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Elective Taxation on Inbound Real Estate Investment

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ELECTIVE TAXATION ON INBOUND REAL ESTATE INVESTMENT

David J. Herzig

Since 1980, the United States has taxed U.S. real property gains of foreign investors. A nonresident must pay tax on the capital gain from the sale of U.S. real property or rights in U.S. real property, as well as on the sale of shares in non-publicly held domestic corporations that hold significant U.S. real property assets. The United States imposes a withholding liability on the purchaser based on a percentage of the purchase price. Moreover, by owning U.S. real property, foreign investors are subject to Internal Revenue Service (“IRS”) investigatory powers. Because of these rules, foreign investors spend significant resources to structure investment in U.S. real property assets to avoid being deemed an owner of the underlying real property for taxation purposes. This has rendered the underlying statute, the Foreign Investment in Real Property Act of 1980 (“FIRPTA”), elective. This electivity results in the United States exhibiting tax haven characteristics for inbound real estate investments. Rather than tightening the rules to eliminate this friction, Congress has recently proposed even looser requirements. The resulting narrative by practitioners and policy makers is that FIRPTA should be eliminated. The United States currently needs more, not less, collection of taxation. The fact that FIRPTA is either easily arbitraged or not properly collected should not result in the repeal.

This Article proposes a new way of addressing FIRPTA by expanding the use of reporting requirements to capture the leakage and provide a mechanism for effectively eliminating the use of structuring to avoid the tax. Through the introduction of systems recently employed in the Foreign Account Tax Compliance Act (“FATCA”) regime, Congress can implement an effective penalty structure to ensure proper collection of taxation and achieve the stated goal of

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FIRPTA—an equal tax burden independent of the status of the investor. The goal of the proposal is to have a more cohesive and coherent FIRPTA regime by replacing a gross income tax regime with a net income tax regime with a backup withholding. Given the United States’ position as a market leader in a limited market, there should be a more aggressive tax collection stance taken. The U.S. real property market is relatively inelastic as compared to equities; thus, an aggressive U.S. position will not have much if any downside.

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I. INTRODUCTION

The United States continues to rely more heavily on foreign capital for real estate and infrastructure investments. Special interest groups and members of Congress have advocated for the need for even more direct investment in the U.S. real estate market. These groups claim that the U.S. real estate market requires roughly $1 trillion to “rebalance loans that are now ‘underwater’ and to facilitate refinancing of maturing commercial real estate debt.” According to advocates, the need for infrastructure and real estate investments necessitates the most favorable investment paradigm.

There has been a concerted push by these groups to modify any barriers of entry for foreign investors into the U.S. real estate market. In order to create the favorable investment paradigm, it has been argued that the largest barrier for foreign investors, the Foreign Investment in Real Property Act of 1980 (“FIRPTA”), should be eliminated or loosened. The failure to do so “makes it more likely such investors will steer their money into non-U.S. real estate (e.g., in emerging Chinese or Indian real estate markets), or non-real estate assets.” In both 2010 and 2011, legislation was proposed to make the FIRPTA requirements even


less stringent, thus creating an even more attractive investment atmosphere for foreign investors. 8

But the United States has dual goals regarding this inbound investment: not only to increase the attractiveness of the investment environment, but also to not decrease the collection of taxing revenues. 9 FIRPTA is designed to ensure the collection of the tax. 10 The FIRPTA rules specifically were designed to ensure equal tax treatment of foreign and domestic investors by ensuring collection of tax on inbound investments. 11 Despite the equal treatment aim, however, the United States has created an inbound investment environment where the rules are both easily avoided, and becoming less stringent. 12 The effect is that foreign investors have an advantage.

The pendulum has swung so far that, in attempting to attract foreign investors, the United States may be unnecessarily acting like a developing nation, giving up autonomy over its affairs in exchange for foreign direct investment. 13 The problem with the current rules is that despite the current economic conditions, the need for more capital, and the tax conditions, the United States continues to be attractive for foreign investors. 14 The strength of the U.S. real estate credit market and the developed U.S. bankruptcy system create an ideal portfolio investment.

There are three distinct problems that the current incarnation of FIRPTA creates. First, there is no anti-abuse rule to stop structuring. 15 Second, there is a need to move closer to microeconomic efficiency of in-

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8. The legislation generally stalls because it cannot be shown with certainty how much foreign investment FIRPTA is inhibiting, what the revenue “offset” would be, and the political ramifications of supporting a lowering of a tax only affecting foreign investors. See infra Part II.D.


10. Not only is FIRPTA intended to have a tax bite at 35%, but it also requires non-U.S. investors to file U.S. tax returns and submit to the investigatory and subpoena powers of the IRS.


12. See Taylor, Blockers, supra note 2, at 9–11.


15. See, e.g., Brunson, supra note 2, at 237–41; William A. Klein & Eric M. Zolt, Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?, 66 U. Colo. L. Rev. 1001, 1006–07, 1013 (1995) (investigating such questions as (1) why are taxpayers allowed to choose which tax regime that applies to their entity, and (2) if we are going to allow the choice, why is there a cost/price in electing favorable tax treatment? The authors conclude that it does not make sense to force taxpayers to adopt complicated, awkward, and inefficient forms merely to reduce tax liability).
bound investment. Finally, there is the lost revenue through concealment of assets. All these derive from the primary problem, from a tax perspective, that FIRPTA is an elective tax creating investment distortions for foreign investors. This is contrary to the goal of the tax code—creation of a frictionless investment environment. This elective taxation through counsel creates deadweight loss and decreases efficiency. For example, if “a taxpayer faces two investment opportunities, one of which, Opportunity A, has an expected value of $X and the other of which, Opportunity B, has an expected value of $.9X, ... the taxpayer would choose Opportunity A.” Taxes often distort the choice, and after taxes, make Opportunity B the choice. “In the example, $0.9X rather than $X of total social wealth is created, simply because the ultimate value to the taxpayer is greater if the non-wealth-maximizing choice is made.”

Thus, there is considerable social waste in a system that has the arbitrary taxation of FIRPTA. FIRPTA creates an inefficient marketplace for foreign investors in U.S. real property. If the primary goal is to encourage foreign investment, this inefficiency should be eliminated. If there is an important tax rationale (e.g., protecting the tax gap) to keep FIRPTA, however, then there needs to be modification of the existing rules.

To prevent elective avoidance of FIRPTA, Congress should require information reporting from financial institutions or other entities that

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17. RER POLICY 2011, supra note 3, at 10; BAILY & SLAUGHTER, supra note 5, at 11--13; ROSEN ET AL., supra note 5, at 1.
19. Diane M. Ring, One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage, 44 B.C.L. REV. 79, 126 (2002); David M. Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312, 1315--16 (2001) (using “frictions” to explain why in some cases taxpayers pursue close substitutes of a prohibited transaction and in other cases they do not); Daniel N. Shaviro, Economic Substance, Corporate Tax Shelters, and the Compaq Case, 21 TAX NOTES INT’L 1693, 1712 (2000) (in the context of corporate tax shelter evaluations, there is dead weight loss where we push taxpayers to structure their transactions even more inefficiently to obtain a tax benefit); James W. Wetzler, Notes on the Economic Substance and Business Purpose Doctrines, 92 TAX NOTES 127, 128 (2001) (“To the extent that taxpayers still undertake tax planning despite the deadweight loss [caused by restructuring the transaction to avoid the tax penalty], a permissive approach to tax planning would be preferable because it would avoid the costs represented by the deadweight loss.”); see also George K. Yin, Getting Serious About Corporate Tax Shelters: Taking a Lesson from History, 54 S.M.U. L. REV. 209, 216--18 (2001) (using “incremental changes” in tax law to combat tax shelters may produce more inefficiency and distortion if taxpayers decide to pursue an alternative but more costly path to their tax benefit).
21. Id.
22. See supra notes 17--21 and accompanying text.
23. This is the position advocated in various reports issued by special interest groups. See generally BAILY & SLAUGHTER, supra note 5 (advocating for FIRPTA reform to benefit the commercial real estate market); ROSEN ET AL., supra note 5 (“[T]he sizable economic benefits of reforming FIRPTA would exceed the small fiscal costs it would entail.”).
process real property sales. Moreover, to assert its full jurisdiction over U.S. real property, FIRPTA should tax not only direct, but also, indirect sales of real property. The resulting position will allow the United States to capture the current leakage and level the playing field for domestic and foreign investors.24

To support this thesis, Part II of this Article will examine the historical basis of FIRPTA. The legislative history demonstrates two main rationales for the enactment of FIRPTA in 1980. First, there was the xenophobic view of the world in 1980.25 There was real concern at the time, although not supported by the actual data, about foreign ownership of U.S. real property.26 Second, there was the appearance of an unfair tax treatment of foreign investors.27 The primary concerns expressed in the debates leading up to the 1980 legislation were that (1) the exemption from capital gain taxation encouraged foreign investors to bid up the price of farmland, and (2) there should be tax equity between U.S. and foreign investors.28 Readers who already have an in-depth understanding of the tax provisions of FIRPTA and the structuring associated therewith may wish to start reading with Part IV.

Part III of this Article will examine the ease with which FIRPTA can be avoided through various legal structures. Given the apparent social waste associated with FIRPTA, is it necessary to retain the tax? In order to advocate for the elimination of FIRPTA, the question of whether FIRPTA is a desirable inefficiency must be addressed.

Thus with the apparent xenophobic focus of the 1980 legislation and the avoidance through structuring, Part IV of this Article will then examine if there are other rationales for the retention or rejection of FIRPTA. This Part will discuss the justifications of a sovereign for retaining the right to tax its real property, including the larger discussion of the source rules applied in international tax literature. Finally, this Part will examine the underlying rationales for taxing the ownership corporate shares that should apply to real estate. These results are especially true in sovereign land ownership regimes where the sovereign does not own all lands.29

Part V will then conclude that there are desirable frictions and that FIRPTA should be modified to become effective. This Part will show that FIRPTA-type frictions are being expanded and not contracted. For example, Congress adopted a FIRPTA type withholding system in the

24. See infra Part V.
25. Kaplan, supra note 11, at 1092--95.
27. Fleischer, supra note 11, at 463--65; Kaplan, supra note 11, at 1092--95.
28. Treasury Report, supra note 26, at 47.
recent Foreign Account Tax Compliance Act (“FATCA”). Rather than attempt to successfully identify all the impermissible foreign bank accounts, Congress relied on third party collection agents—the banks—to identify and collect the taxation due. This Article concludes that source countries should be permitted to tax the underlying real property. Then to build upon this conclusion, new legislation will need to be enacted that will capture the leakage under the current FIRPTA rules. This Part will provide a new framework by suggesting that all buyers of U.S. real property would need to receive a W-9 or appropriate W-8 from the seller or withhold the appropriate tax due.

II. LEGISLATIVE HISTORY OF FIRPTA

FIRPTA is a surprisingly easy statute to explain. “FIRPTA generally taxes a foreign person’s gain from the direct or indirect disposition of U.S. real property interests (“USRPIs”) as income effectively connected with a U.S. trade or business, thereby exposing foreign persons to tax at the rates applicable to U.S. persons.” The sale of a USRPI is treated as effectively connected income subject to U.S. tax. It generally is recognized that a variety of property ownership interests, such as working interests in oil and gas properties in the United States, are also USRPIs. FIRPTA captures not only direct ownership, but also ownership in a partnership owning such interests. Such ownership constitutes the ownership of a USRPI as well as the conduct of a U.S. trade or business. In contrast, royalties generally are considered “passive” income subject to the 30% (or lower treaty rate) tax.

FIRPTA originated at a time when there was a clear sentiment against foreign ownership of U.S. real property. There was an interesting narrative leading up to the enactment of FIRPTA. During the early 1970s, an increasingly hostile public discourse began ultimately leading to proposed legislation and a Treasury Report on the consequences to the

31. TREASURY REPORT, supra note 26, at 47.
34. I.R.C. § 897(a)(1).
35. Id. § 897(c)(1)(A)(i).
36. Id. § 897(c)(4).
37. Id. § 897(c)(4)(B).
39. Fleischer, supra note 11, at 491–92; Kaplan, supra note 11, at 1092–95; Knoll, supra note 13, at 713–14.
The final result of this groundswell was the enactment of the FIRPTA legislation in 1980. FIRPTA was intended to resolve the structuring machinations that were utilized by foreign investors to avoid taxation on the sale.


Prior to the 1960s, U.S. source investment capital gains of non-resident aliens ("NRAs") were not taxed. The most common rationale was that the location of assets was hard to determine. Real estate and certain tangible property were the exception.

In the late 1960s, section 871 of the Code was enacted; it taxed foreign persons engaged in a trade or business within the United States on their net income effectively connected with their U.S. trade or business. The section 871 requirement, in application, has four distinct elements. Each element must be present for the imposition of taxation by the United States: (1) U.S. source income; (2) that is "effectively connected"; (3) to a "trade or business"; and (4) that is carried on in the United States.

For section 871 to apply in the pre-FIRPTA rule frame, each of the four elements would need to be present for a foreign real estate investor. In the case of a foreign real estate investor, the first requirement is clearly met. Rental or lease income from domestic real estate, developed or otherwise, is considered U.S. source income under the statutory sourcing rules. Generally, the fourth requirement is satisfied. If the investor’s real estate activities constitute a “trade or business,” it will be considered car-

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40. See TREASURY REPORT, supra note 26, at 15; Kaplan, supra note 11, at 1104-05.
41. Kaplan, supra note 11, at 1095.
42. Id. at 1104.
44. “These nonresident aliens are exempted under the House bill from the tax on capital gains, including hedging transactions, it being found administratively almost impossible to collect the capital-gains tax in such cases. This exemption will result in increased revenue from transfer taxes or from the income tax in the case of persons carrying on the brokerage business.” 80 CONG. REC. 8650 (1936); see also H.R. REP. NO. 74-2475, at 9–10 (1936); S. REP. NO. 74-2156, at 21–23 (1936).
50. Id. § 861(a)(5).
ried on in the United States. The main issues in pre-FIRPTA rules are the second and third requirements. The central question is whether a foreign investor’s real estate activities constitute a “trade or business.” Because, like the fourth requirement, if a real estate investor’s activities constitute a “trade or business,” generally the income and sale profits will be considered “effectively connected” to that trade or business.\textsuperscript{51}

Whether ownership of rental real estate constituted a U.S. trade or business depended on the facts and circumstances, including the size of the investment, the number and terms of the leases, and the nature of the property.\textsuperscript{52} Net leasing one property would likely not have been treated as engaging in a trade or business.\textsuperscript{53} The greater the number of tenants, the shorter the lease terms; the greater the share of the costs incurred by the lessor, the more likely the lessor would have been deemed engaged in a U.S. trade or business.\textsuperscript{54}

A foreign investor whose ownership of real property did not raise to the level of a U.S. trade or business (or if there was uncertainty) could elect to treat all income or gain from real property held for the production of income as income effectively connected with a U.S. trade or business.\textsuperscript{55} Once made, this election remained in effect for all subsequent years and could only be revoked with the consent of the Service.\textsuperscript{56}

Although the taxpayer election could clarify the rules, section 871 was an opt-in requirement.\textsuperscript{57} Many taxpayers, however, did not opt-in because there were ownership structuring mechanisms that allowed the avoidance of U.S. taxation on liquidation of the real estate.\textsuperscript{58} For example, gain on liquidation of a corporation, as well as gain on the sale of a corporation’s assets followed by a liquidation of the corporation were, with specific exceptions, tax-free.\textsuperscript{59} A properly structured ownership enti-

\textsuperscript{51} Id. \S 864(c)(2)(A); Treas. Reg. \S 1.864-4(c)(1)(i) (2013). The test is whether the income in question is “derived from assets used in, or held for use in, the conduct of [the taxpayer’s] trade or business.” Id.

\textsuperscript{52} See Kaplan, supra note 11, at 1098.

\textsuperscript{53} Rev. Rul. 73-522, 1973-2 C.B. 226; I.R.S. Tech. Adv. Mem. 80-29-005 (Mar. 27, 1980) (ownership of working interests in U.S. oil and gas properties was a U.S. trade or business). But the Court of Claims rejected the IRS’s holding in Tech. Adv. Mem. 80-29-005 in Di Portanova v. United States, 690 F.2d 169, 174 (Cl. Ct. 1982) (“To be engaged in the oil business requires active involvement, personally or through an agent, in the operation of that business.”). But see Lewenhaupt v. Comm’r, 221 F.2d 227, 227 (9th Cir. 1955) (selling four U.S. properties was a U.S. trade or business); Pinchot v. Comm’r, 113 F.2d 718, 719 (2d Cir. 1940) (considerable leasing and management activities with respect to eleven improved U.S. properties constituted a U.S. trade or business); De Amodio v. Comm’r, 34 T.C. 894, 898-99 (1960), aff’d on other grounds, 299 F.2d 623 (3d Cir. 1962) (leasing two U.S. properties was a U.S. trade or business).

\textsuperscript{54} Id. \S 871(d), 882(d) (2012).

\textsuperscript{55} Id. \S 871(d).

\textsuperscript{56} See Pinchot, 113 F.2d at 719.

\textsuperscript{57} Id.

\textsuperscript{58} B YRNES, HERZIG, & SOVE, supra note 45.

\textsuperscript{59} In 1980, the General Utilities doctrine had not been yet repealed. Gen. Utilities & Operating Co. v. Comm’r, 296 U.S. 200, 205 (1935). Similarly, corporate buyers could purchase stock and generally obtain a step-up in asset basis under former section 334(b)(2). I.R.C. \S\S 336-337, as in effect prior to the Tax Reform Act of 1986, Pub. L. No. 99-514 (“1986 TRA”). Treaties with “tax haven” jurisdictions, such as the Netherlands Antilles and the British Virgin Islands, had not been terminated.
ty would allow the taxpayer to avoid taxation instead of electing into taxation.60

B. Government Reaction

As early as 1970, the New York Times reported that “[f]oreign investors of moderate means are increasing their holdings in real estate in the United States through purchase of shares in so-called ‘offshore’ funds.”61 The fear of foreign ownership of U.S. lands had reached a peak by 1978. It was reported that “the rush among Europeans to buy farm land in the Midwest has pushed per-acre prices to record levels in a number of states.”62 By the late 1970s, seven states had enacted laws barring nonresident aliens from owning land, and thirteen other states had imposed some limits.63

Not only was there fervor about foreign ownership, but also about the aforementioned disparate tax treatment of similar investors. Thus, during the Revenue Act of 1978, a proposal was included to tax capital gain on the sale of agricultural land.64 The primary concerns expressed in the Senate debate were that (1) the exemption from capital gain taxation encouraged foreign investors to bid up the price of U.S. farmland, and (2) there should be tax equity between U.S. and foreign investors.65 Since this was the first time a measure like this was proposed, and the issue was not yet ripe in the political process, the provision was withdrawn and sent to Treasury to issue a report on “the appropriate tax treatment to be giv-

60. There were other tax rules at that time that also supported the use of structuring. For example, long-term capital gain of corporations as well as individuals enjoyed a preferential rate; the top ordinary income bracket was 70%; depreciation methodologies were limited (accelerated depreciation, but not ACRS or MACRS depreciation, was permitted for buildings); and, most importantly, the passive activity loss rules had not been enacted.

61. David A. Andelman, Foreign Investment in U.S. Property Growing, N.Y. TIMES, Mar. 15, 1970; see also Carter B. Horsley, Foreign Investment in U.S. Properties Growing, N.Y. TIMES, Sept. 2, 1973 (“L]arge [foreign] investors of wealth and sophistication’ had replaced the small foreign investors active in offshore investment funds in the nineteen-sixties.”) (quoting John R. White, President of James D. Landauer Associates); Foreign Investing Held Strain on U.S., N.Y. TIMES, Jan. 21, 1974 (reporting that Illinois Senator Adlai E. Stevenson would begin hearings on the situation; Stevenson observed that “[f]oreign buyers are driving up land costs in many areas, and foreign ownership of natural resources like coal mines, timber and farm land can divert critical raw materials overseas instead of into the United States market”).

62. Michael Goodwin, Everybody’s Getting In on Foreign Investor Action, N.Y. TIMES, July 2, 1978, at 4; see also Kaplan, supra note 11, at 1092.

63. By 1978, the following states had enacted statutes: Connecticut, Indiana, Kentucky, Mississippi, Nebraska, New Hampshire, and Oklahoma. These provisions are compiled in 1 U.S. DEP’T OF AGRIC., MONITORING FOREIGN OWNERSHIP OF U.S. REAL ESTATE 58–94 (1979); Comm. on Foreign Inv. in U.S. Real Estate, Foreign Inv. in U.S. Real Estate: Federal and State Laws Affecting the Foreign Investor, 14 REAL PROP. PROB. & TRUST J. 1, 18–40 (1980); Javade Chaudhri & Jessie-Kay Weili Cheng, Note, Regulation of Foreign Investment in U.S. Real Estate, 33 TAX LAW. 586, 613–15 (1980) (summarizing state laws restricting foreign land ownership, limiting duration of ownership, and setting acreage limitations); Robert Lindsey, Foreign Investors Rush to Acquire U.S. Property as Haven for Funds, N.Y. TIMES, May 14, 1978, at 40; Tax Sought on Foreign Farm Deals, N.Y. TIMES, Aug. 19, 1979, at D2 (reporting that before the Iowa legislature banned all new sales to foreigners, “a two-year survey revealed that foreigners owned only 15,000 out of 36 million arable acres in Iowa”).

64. See Pub. L. No. 95-600, 92 Stat. 2763 § 553.

65. TREASURY REPORT, supra note 26, at 47.
en to income derived from, or gain realized on, the sale of interests in United States property held by nonresident aliens or foreign corporations.\(^66\) Treasury issued its report in 1979.\(^67\) The Report first clarified that the narrative of foreign ownership tipping to critical mass was incorrect.\(^68\) The limited data available at the time showed relatively little foreign investment in U.S. real property generally and only slightly more proportionately in U.S. agricultural land.\(^69\) For example, foreign persons owned only 0.3% of agricultural land in the counties surveyed.\(^70\) In 1977 and the first half of 1978, foreigners purchased land constituting 2% of the total acreage sold and perhaps 4% of the total value sold.\(^71\)

The Report highlighted the main structuring mechanisms that foreign investors could use which had tax benefits not available to U.S. investors. Those five structures were: (1) installment sales;\(^72\) (2) like-kind exchanges;\(^73\) (3) section 337 sales;\(^74\) (4) sale-liquidations;\(^75\) and (5) treaty shopping.\(^76\) The structuring ability of some foreign investors to avoid tax on their U.S. real estate gains results primarily from the statutory requirement that such gains be derived from a “trade or business” in order to be subject to U.S. tax.\(^77\)

\(^66\) Revenue Act § 553.  
\(^67\) TREASURY REPORT, supra note 26, at 1.  
\(^68\) Id. at 7-9

\(^69\) See id. at 8-9 (citing U.S. Gen. Accounting Office, Foreign Ownership of U.S. Farmland, Much Concern, Little Data, June 12, 1978 [hereinafter GAO, Foreign]) (For example, total receipts of foreign corporations the principal activity of which was real estate and total receipts of foreign-owned U.S. corporations engaged in real estate were only 3% of the total receipts of all real estate corporations and 1% of the total receipts of U.S. real estate corporations and partnerships).

\(^70\) Id.  
\(^71\) Id. (citing GAO, Foreign).

\(^72\) If the foreign person was not actually engaged in a trade or business in the years in which payments were received, the gain would not have been treated as effectively connected and would therefore have gone untaxed.

\(^73\) If U.S. real property is exchanged for foreign real property of like-kind, such an exchange would have been tax-free and gain from the sale of the foreign property would not have been subject to tax.

\(^74\) The sale of property by a company holding real property coupled by a complete liquidation of the company within one year. Under pre-General Utilities repeal I.R.C. § 337, the sale would have been generally tax-free and gain on the liquidation would not have been subject to tax.

\(^75\) A sale of shares of a company holding real property followed by the purchaser liquidating the holding company. The sale of shares would not be subject to U.S. tax. The liquidation would have been tax-free at the corporate level, except for recapture items, and the purchaser would have realized no gain (having obtained a stock basis equal to fair market value on the purchase of the stock).

\(^76\) An investment in U.S. real property through a foreign corporation located in a jurisdiction which had a treaty with the United States permitting an annual election to treat rental real estate income as subject to tax on a net basis. A foreign corporation in such a jurisdiction would have made the election for years during which it owned the real estate, but would not have so elected for the year in which it sold the real property. TREASURY REPORT, supra note 26, at 46. See, e.g., Convention Between the United States of America and the Netherlands Antilles with Respect to Taxes on Income (the “NA Treaty”), Article X, partially terminated as of January 1, 1988, with the interest article terminated except for debt owing to a financing subsidiary that was issued on or before October 15, 1984, effective December 30, 1996. The same treaties often had a provision preventing the United States from imposing its secondary withholding tax on dividends or interest paid by the foreign corporation that were attributable to income from its U.S. business. See NA Treaty, article XII.

\(^77\) Kaplan, supra note 11, at 1103.
The Report was very critical of the structuring mechanisms used by foreign investors.78 The Report, however, was cautious in the manner to remedy the perceived structuring problems.79 It noted, for example, that taxing capital gain on the sale of shares in a corporation owning U.S. real estate would be a departure from prevailing international norms and would be difficult to enforce.80 For example, in the case of a “like-kind” exchange, it may be easier to impose a tax when U.S. property is exchanged for foreign property than when the foreign property is subsequently sold.81

After the structuring discussion, the Report concluded that by avoiding tax on the sale of U.S. real property, a foreign investor probably bore a lighter U.S. tax burden than domestic investors.82 The Report continued to state that the investor might bear a heavier burden if such gain were subject to tax.83 Most important for the development of the 1980 legislation, the Report also noted that taxing gain on the sale of all U.S. real estate (whether or not effectively connected with a U.S. trade or business) would generally be consistent with international tax practice.84

After the 1979 Report, Treasury set forth the framework for the 1980 drafting of the FIRPTA legislation.85 There was a clearly identifiable distortion between foreign and domestic investors regarding domestic real estate.86 The extent of the impact on the fisc was yet to be determined. Clearly, however, there was public pressure and a public narrative that this was a problem that needed to be addressed. Treasury’s recommendations were made in accord with its belief of international tax norms. For example, Treasury did not advocate a tax on the sale of shares of a corporation owning real property.87

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78. T REASURY REPORT, supra note 26, at 35.
79. See id. at 46–48.
80. Id. at 53 (“This, in turn, suggests than an appropriate and effective remedy may focus on one or more steps in the various processes by which gains which should be taxable are converted into tax-exempt gains.”).
81. Id. Similarly, it may be more difficult to impose a tax on the sale of corporate shares of a holding company, but it appears possible to deny the new owner an all but tax-free liquidation and step-up in basis.
82. Id.
83. Obviously, this is subject to much debate as there are many variables in the calculation of taxation. The report hypothesized that foreign investors were less likely than U.S. investors to have other U.S. income to offset with net losses from real estate investments. Id. at 50.
84. Id. at 52.
85. See T REASURY REPORT, supra note 26, at 50–52.
86. Id.
87. The letter transmitting the report to the House Ways and Means Committee was even more explicit on this point, stating: “The Treasury does not believe that taxing capital gain on the sale of corporate shares is desirable or practical. But to prevent unintended tax avoidance, the Treasury recommends modifying certain specific statutory provisions under which foreign taxpayers convert taxable gain on real estate into nontaxable gain.” Letter from W. Michael Blumenthal, Sec’y of the Treasury, to the Honorable Al Ullman, Chairman of the Comm. on Ways and Means, House of Representives (May 4, 1979).
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C. 1980 Legislation

In order to address the structuring problems identified in the Treasury Report, Congress would need to change the definitional standards surrounding the use of “effectively connected” in the context of U.S. real property. But rather than modify the international taxation norm, Congress, in FIRPTA, supplied a statutory condition precedent. Thus, [the gain] of a nonresident alien individual or a foreign corporation from the disposition of a United States real property interest shall be taken into account . . . as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain . . . were effectively connected with such trade or business.

This new statutory structure scheme would treat all gains as “effectively connected” if they resulted from a “United States real property interest.” Further, gains would be taxed at domestic rates for domestic taxpayers.

Thus, the key to the new legislation was a new definitional term for “United States real property interest.” Rather than have the term limited to a fee simple property ownership, the definition was more expansive, including leasehold interests among others. At the time, such leaseholds were not considered a typical real estate investment. The 1979 Treasury Report, however, did not address “real estate acquired for use in a non-real-estate business (e.g. a manufacturing plant);” it was “concerned only with real estate which was leased or held for investment.”

Congress did not stop there. It addressed the structuring problems created through the use of corporations. FIRPTA defined “real property interest” to include “any interest (other than an interest solely as a creditor) in any domestic corporation.” Thus, stock in a domestic corporation, or a loan to a company in which the investor also holds stock, is a “real property interest.” Although this rule would seem straightforward, it should surprise no one that in a tax context, there are often murky lines, even in determining when an interest represents ownership of a corporation. For example, sometimes nominally titled debt is in effect equity. In the domestic context, there are regulations and cases sorting

88. Kaplan, supra note 11, at 1104.
90. Id.; see also I.R.C. §§ 11, 55, 871(b)(1), 882(a)(1), 897(a)(1), 1201(a). But see id. § 897(a)(2) (modification of minimum tax on tax preferences as applied to nonresident aliens).
91. Kaplan, supra note 11, at 1104.
92. Id.
93. Id. at 1104–05.
94. TREASURY REPORT, supra note 26, at 2.
96. Id.
through those lines.\textsuperscript{98} In the 1980 legislation, however, there were no regulations, and the domestic regulations expressly disclaimed applicability to foreign uses.\textsuperscript{99}

As it turns out, the rule to include corporations was subject to two major exceptions. The first exception covers stock that is “regularly traded on an established securities market,” unless the investor holds more than 5% of that company’s stock.\textsuperscript{100} The purpose of this exception was to prevent the application of FIRPTA to shareholders in publicly traded companies.\textsuperscript{101} For example, although energy and gas companies own a lot of U.S. real estate, those shareholders would not be subject to FIRPTA.\textsuperscript{102}

The second exception applies to stock of a corporation that was not a “United States real property holding corporation” during the period in which the foreign investor held its stock.\textsuperscript{103} This exception applies if a corporation holds less than 50% of its real estate interests (both domestic and foreign) for use in a trade or business.\textsuperscript{104} At the time of enactment, the concept was that a tiered structuring would not be possible because of the look-through rules in the statute.\textsuperscript{105} If, for example, a corporation owns a “controlling interest” in a subsidiary corporation, the assets of that subsidiary are imputed pro rata to the parent in determining the parent’s status as a “United States real property holding corporation.”\textsuperscript{106}

Congress understood the nature of unintended consequences; therefore, the statute stated that the Treasury should issue regulations “to prevent the avoidance of Federal income taxes.”\textsuperscript{107} The Committee Report mandates that gain be recognized whenever property “would not be subject to tax on a later disposition of the property by the recipient.”\textsuperscript{108} The intent was for the Treasury to facilitate normal business transactions, but only when the ultimate taxability of gain is not in jeopardy.\textsuperscript{109}

\textbf{D. Recent Proposed Legislation}

FIRPTA has not been stagnant in application. But rather than a restrictive interpretation as was envisioned during the late 1970s and 1980 legislation, there has been a recent push to expand the exceptions origi-

\begin{tabular}{l}
100. I.R.C. § 897(c)(3). \\
101. Kaplan, supra note 11, at 1105. \\
102. Id. \\
103. I.R.C. § 897(c)(1)(A)(ii). \\
104. Id. § 897(c)(2). \\
105. Id. § 897(c)(5)(A). \\
106. Id.; see also Temp. Treas. Reg. § 6a.897-1(f) (imputing ownership of assets to shareholders, partners, or beneficiaries); Kaplan, supra note 11, at 1106-07. \\
107. I.R.C. § 897(e)(2). \\
109. Id. at 280.
\end{tabular}
nally built in. The xenophobic narrative in the 1970s has been replaced. With the global economic meltdown of the last ten years, there is now a push for more foreign investment in the United States. The recent legislation proposed starting in 2010 demonstrates the movement away from the original intent of the statute. Special interest groups have pushed for this legislation in order to encourage capital infusions into the United States by foreign investors.

The legislation would amend FIRPTA by removing some of the artificial tax barriers to foreign investment in U.S. real estate. The proposers of the bill claimed that such changes are important to eliminate the current tax bias in favor of debt financing and to assist U.S. real property owners in accessing equity capital from around the world at this time of great distress in the debt and broader financial markets.

The bill would modify FIRPTA in a number of ways that could impact the taxation of foreign investors that own interests in domestic real estate investment trusts ("REITs"). Several of the modifications relate to the percentage of stock that a foreign owner may hold in a publicly traded REIT before becoming subject to FIRPTA. The main provision was to increase the ownership threshold from 5% to 10%.

Despite the repeated support by Congress to try to pass the bills, they both failed. What rationales would cause seemingly benign legislation to fail? The proposed legislation did not eliminate FIRPTA, but rather, slightly expanded the scope of the exemption. There are three main theories on why the proposed legislation has failed. The first two are monetary. The first is the amount of economic loss preventing foreign investment as a result of FIRPTA. The second is the corollary that would be quantifying the amount of the loss of tax revenue from the

110. See BAILY & SLAUGHTER, supra note 5.
111. See id.; ROSEN ET AL., supra note 5.
113. See ROSEN ET AL., supra note 5.
114. Id.
115. Id.
116. Taylor, Repealed, supra note 33, at 38.
117. Id. at 41.
118. This means that with respect to foreign persons owning not more than 10% of a publicly traded REIT, (i) a sale of REIT stock by the foreign owner would not be subject to FIRPTA (regardless of whether the REIT is domestically controlled), and (ii) capital gain distributions to the foreign owner that are attributable to gains from the disposition of USREIs held by the REIT would not be treated as effectively connected income under FIRPTA, but instead would be treated as ordinary dividends (subject to US withholding at a 30% rate, or lesser treaty rate).
120. Taylor, Repealed, supra note 33, at 41.
121. BAILY & SLAUGHTER, supra note 5, at 8.
elimination of FIRPTA. The final is simply the same xenophobic view of the world as in 1980.

There have been numerous attempts by special interest groups to quantify the magnitude of the first order problem of FIRPTA. The Real Estate Roundtable conducted two studies, one in 2009 and another in 2011, to try to resolve the question. The reports, however, are unable to quantify exactly how much foreign investment FIRPTA is inhibiting. “It is difficult to quantify exactly how much foreign capital into U.S. commercial real estate is deterred by FIRPTA.” The reports instead rely on anecdotal evidence that FIRPTA inhibits the flow of foreign capital into the U.S. real estate market because “FIRPTA discourages international investors from placing capital in U.S. real estate by levying additional taxes on equity investment that do not apply to other asset classes.” The fallacy of these assumptions is that foreign investors are impacted by FIRPTA. FIRPTA is elective for foreign investors because of the structuring mechanisms. Thus, for sophisticated foreign investors that would be able to provide the capital—over $1 trillion—needed to support the market, FIRPTA is optional for them already. Therefore, not only can the amount FIRPTA is inhibiting not be proven, it is unlikely that FIRPTA prevents any investment inflow into the U.S. real estate market.

The more important Congressional concern is not how many foreign investors are not buying U.S. real estate, but rather the tax effect of the elimination of FIRPTA—the so-called “tax offset.” The stated problem with FIRPTA is that it generates very little revenue. “The Joint Committee on Taxation recently estimated that outright FIRPTA repeal would cost $8.3 billion over 10 years, less than $1 billion per year.” Thus, the argument is that since FIRPTA’s investment distortion is high and the revenue generated is low, FIRPTA should be eliminated. “On balance, we think the sizable economic benefits of reforming FIRPTA would exceed the small fiscal costs.” Once again, both the Joint Committee’s report and the special interest studies fail to address that FIRPTA’s tax impact is de minimis because it is elective through

122. Id. at 10.
124. BAILY & SLAUGHTER, supra note 5; ROSEN ET AL., supra note 5.
125. BAILY & SLAUGHTER, supra note 5, at 8.
126. ROSEN ET AL., supra note 5, at 1.
127. See Taylor, Blockers, supra note 2, at 9–11.
128. BAILY & SLAUGHTER, supra note 5, at 3–6.
129. Id. at 10.
130. Id.
131. Id.
132. Id.
133. Id.
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structuring. The more prudent course is to effectively capture the leakage rather than accept the minimal impact of the current elective form.

Although the proposed legislation only modified the existing rules in a minimal manner, the proposal failed to garner any support primarily because it failed to quantify the impact of the legislation on revenue.134

III. INVESTMENT TECHNIQUES

FIRPTA was designed to collect tax without regard to the pre-1980 structuring techniques. Unfortunately, advisors just moved from the pre-1980 structuring to the post-FIRPTA structuring techniques. There are three main ways that investors deal with the FIRPTA issues: (1) high yield debt instruments; (2) REITs; and (3) blocker corporations.135 Each structure is designed for foreign investment in U.S. real property without triggering FIRPTA. The structures all have certain benefits and detriments. For example, the following menu of choices provided by many law firms, including Cooley and White and Case.136

TABLE 1

<table>
<thead>
<tr>
<th>Structure/ Considerations</th>
<th>Effective U.S. Tax Rate on Distributions¹</th>
<th>Non-U.S. Investor Tax Filing Obligation</th>
<th>Barriers to Formation</th>
<th>Expected Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Yield Debt Investment</td>
<td>Can be as low as 0%</td>
<td>No</td>
<td>High-Upside must be limited</td>
<td>Medium</td>
</tr>
<tr>
<td>Leverage Blocker (and alternatives)</td>
<td>Can be between 20% and 35%¹</td>
<td>No—Blocker files</td>
<td>High—Complexity</td>
<td>Medium—High</td>
</tr>
<tr>
<td>Private REIT</td>
<td>Can be between 0% and 54.5%⁴</td>
<td>Yes, but only in certain cases⁴</td>
<td>Medium—High</td>
<td>Medium—High</td>
</tr>
<tr>
<td>Standard Blocker</td>
<td>Up to 40%—54.5%⁴</td>
<td>No—Blocker files</td>
<td>Low</td>
<td>Low—Medium</td>
</tr>
<tr>
<td>Direct Investment</td>
<td>Up to 54.5%</td>
<td>Yes—Direct</td>
<td>None</td>
<td>Low</td>
</tr>
</tbody>
</table>

A. High-Yield Debt Instruments

There are a number of ways to invest in U.S. real estate. FIRPTA does not apply to investors in U.S. real estate if the investment is a “straight debt.”¹³⁷ For this purpose, straight debt means that (1) the debt is not convertible into an equity interest in the underlying property; (2) the interest rate in the debt is not tied to the performance of the underly-


136. See id.

ing property; and (3) the upside is limited. If the debt is structured properly, and it qualifies as debt for income tax purposes, then a non-U.S. investor could escape U.S. tax under FIRPTA on the repayment of the debt. This is true even if the debt is the economic equivalent of the underlying equity.

The rules create certain structural challenges for the investor. Any mistake results in taxation. First, the instrument cannot be economically equivalent to an equity investment. For example, there cannot be significant upside held by the non-U.S. investor. An unrelated party must invest a material amount alongside the non-U.S. investor as equity. This prevents the debt from being recharacterized as equity. Finally, the non-U.S. investor cannot retain significant control rights over the borrower or the property itself.

Distinguishing debt from equity is not straightforward. Generally, equities are instruments that have no fixed maturity date and “a right for a residual profit that is subordinated to all other claims against the corporation.” “Debt instruments are funds transferred in return for a reasonable expectation of repayment within a fairly short and well-defined period.” Debt instruments often provide their holders with fixed periodical interest payments until repaid. Generally, returns on equity are higher because of the risks associated with the investment, e.g., the many unforeseeable factors related to the success of the firm’s business strategy.

As an investor, the ideal investment paradigm is one with the upside of equity and the downside protection of debt. Financial markets have responded with hybrid instruments that are classified as debt yet have many equity characteristics. The IRS and the courts have been careful to avoid creating any safe harbors or clear lines to distinguish between


140. See Benshalom, supra note 97, at 1228–30.

141. Id.

142. Id. at 1229; see also Anthony P. Polito, Useful Fictions: Debt and Equity Classification in Corporate Tax Law, 30 ARIZ. ST. L.J. 761, 770–71 (1998).

143. Benshalom, supra note 97, at 1229.

144. Id.

145. Id.; see also Richard A. Brealey et al., PRINCIPLES OF CORPORATE FINANCE 147–49 (8th ed. 2006).

debt and equity. This was designed to prevent granting sophisticated taxpayers a roadmap for avoidance. The market, however, would just build this uncertainty into the pricing of the hybrid instruments. The reliance of many Code provisions on the classification of an investment as debt or equity and, most importantly, the material financial consequences the classification often involves cause the debt-equity distinction to be one of the most frequently litigated issues in tax law.

The line between debt and equity can quickly become extremely blurry. For example, in a number of recent transactions, instruments have been issued that are designed to be treated as debt for federal income tax purposes, but to be treated as equity for regulatory, rating agency, or financial accounting purposes. These instruments typically contain a combination of debt and equity characteristics.

An example of these hybrid instruments is provided in Revenue Ruling 2002-31. The Ruling posited a bond with the following characteristics: (1) payments of contingent interest that would be triggered by a specified rise in the value of the bond (and therefore a rise in the value of the underlying stock); (2) payments are in amounts that increase in direct proportion to the dividends paid on the underlying stock; and (3) to the extent the trading value of the bonds reflects the value of the conversion premium, the payments are in direct proportion to the value of the underlying stock. By paying more current interest at a time when conver-

149. For example, prior to the 2010 enactment of I.R.C. Section 871(m), total return swaps were a favorite way of avoiding FIRPTA. See Linda Z. Schwartz, ABCs of Cross Border Derivatives, CADAWALADER WICKERSHAM & TAFT, LLP (June 26, 2015) at 62-34 (A total return swap is a payment under all notional principal contracts (“NPC”) (other than contracts with accelerated or uneven payments, such as swaps with an embedded loan component) that were sourced according to the residence of the recipient. Thus, most payments under an NPC received by a foreign holder were foreign source income not subject to U.S. withholding tax, except, under certain circumstances when the foreign holder was engaged in a U.S. trade or business. This sourcing rule applied to NPCs with respect to debt, commodities, and likely, stock, which permitted foreign holders of dividend-paying stocks who were subject to U.S. withholding on such dividends to swap their stock for the right to receive payments measured by dividends paid on such stock without incurring a U.S. withholding tax. For portfolio investors in countries without U.S. tax treaties, avoiding the 30% withholding tax on dividends was a powerful incentive to forego the voting rights associated with a direct investment in stock. Also, beginning March 18, 2012, I.R.C. Section 871(m) imposes a 30% U.S. withholding tax on any payment made to any foreign party on an NPC (or any substantially similar financial instrument) that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend, except to the extent that regulations are issued that provide that the NPC (or other financial instrument) does not have the potential for tax avoidance. These equity swaps on USRPIs were effectively shut down with I.R.C. § 781(m). Some practitioners, however, continue to push by continuing the swaps because of Treas. Reg. Section 1.897-9T.
151. See, e.g., IRS Notice 94-47.
153. Specifically, Corporation X issues for $625 a 20-year debt instrument with a stated principal amount of $1,000. Except for the contingent interest payments described below, the debt instrument does not provide for any stated interest. The debt instrument is convertible at any time into a number of shares of Corporation X common stock having a value, on the date of issue of the debt instrument,
sion might otherwise be an attractive option to a holder. Contingent Interest Convertible Bonds (“CICB”) are structured to provide an incentive to a holder not to convert early and are even less likely to be converted than conventional convertible bonds.\(^\text{154}\) Accordingly, the conversion option contained therein cannot subject CICB to section 163(l).\(^\text{155}\)

The corporation takes the position that the CICB is debt.\(^\text{156}\) The Service agrees with the corporation.\(^\text{157}\) In the Revenue Ruling, the Service explained the legislative history of section 163(l) with respect to conventional convertible bonds, which, as described above, applies the “substantially certain” test and evaluates the likelihood of conversion by looking to the significance of a bond’s initial conversion premium.\(^\text{158}\) The Ruling explicitly rejects the argument that because the value of the issuer’s stock is used to construct the “projected payment” schedule required by the CPDI rules, that interest on the CICB is per se payable in stock.\(^\text{159}\) Instead, the Ruling bases its conclusion that the bond is not a “disqualified debt instrument” on the application of the “substantially certain” test.\(^\text{160}\)

The upside of using the high-yield debt instrument is that the foreign investor can receive high economic returns without U.S. tax. Properly structured high-yield debt instruments have no U.S. tax on distributions because it is classified as portfolio interest under Sections 871(h) and 881(c) of the IRC.\(^\text{161}\) Portfolio interest is generally defined as a debt obligation held by an identifiable foreign person.\(^\text{162}\) Although Section 871(h) is designed to prevent the use of debt as equity in the foreign context, it has largely been ineffective.\(^\text{163}\) The investor also receives fixed returns that may be better than the underlying investment with a priority credit position.\(^\text{164}\) This may make the debt more valuable than the under-
lying property. Further, when the debt is sold, it is also without tax be-
cause of the standard rules involving the return of basis.165

There has been at least one instance, however, when a company
canceled a debt offering because of FIRPTA issues.166 As just discussed,
convertible debentures (and other debt obligations that participate in the
growth of income or growth in the value of a USRPI) issued by a U.S.
Real Property Holding Company (“RPHC”) to foreign investors are ex-
empt. But in the case of Sun Company—a publicly held U.S. energy re-
source company with substantial USRPI holdings—they cancelled a pro-
posed Eurodollar convertible-debt offering because of the potential
application of FIRPTA.167 This included FIRPTA withholding to the for-
ign debenture holders.168

B. Blockers

1. Standard

The most typical structure is the standard blocker.169 To avoid the
complexities and costs of the more complicated leverage blocker, a
standard blocker can be used. The investment, however, does not elimi-
nate the FIRPTA taxes (as a leverage blocker would) but it does avoid
the reporting.170 The investment is usually made in an offshore company
rather than through the domestic company; the offshore company will
then make the investment in the fund.171

“Using this structure, the blocker functions as the taxpayer, paying
FIRPTA taxes and filing any required tax returns . . . .”172 The blocker,
however, “blocks” the non-U.S. investors from having any tax filing re-
quirements.173 There is no tax efficiency associated with the standard
blocker. In fact, there may be an additional “branch profit” tax.174 Unless
the blocker resides within a jurisdiction with a favorable tax treaty with
the United States, the effective rate may actually rise to 54.5%.175 Stand-
ard blockers are solely used for protection from the IRS investigatory
power.

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167. Id.
168. Id.
170. This is because the reporting is limited to the corporate level. See Taylor, Blockers, supra note 2, at 5.
172. Id.
173. Id.
174. Id.
175. Id.
2. Leveraged

A leveraged blocker is usually a Delaware corporation “that is capitalized with a mix of loans and equity from its investors.” Usually, the ratio of debt to equity is 3:1. “The goal of this structure is to shield non-U.S. investors from the U.S. tax filing requirement that FIRPTA imposes . . . .” Further, the structure reduces “the effective rate of U.S. tax non-U.S. investors will bear on their investment.” A properly structured leveraged blocker: (1) reduces the net taxable income of the blocker through interest expense; (2) the “interest payment will be free of withholding tax;” and (3) “dividend payment on profit will have low withholding tax.”

The leverage blocker structure is as follows:

**LEVERAGED BLOCKER STRUCTURE**

In order to effectively avoid the FIRPTA rules, there are many requirements in a leveraged blocker structure. First, there must be a minimum of three investors. This ensures that foreign investors hold less than 50% of the leverage blocker’s capital. If less than 50% of capital is held in this manner, interest will be deductible. Second, this same mix of investors will be required to “minimize the amount of withholding on the interest payments.” For example, “[a]t least three non-U.S. investors, none of which hold 50% or more of the [l]everaged [b]locker’s capita and all of whom are either residents of a jurisdiction that has a tax

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176. Id. at 5.
177. Id.
178. Id.
179. Id.
180. Id. at 6.
181. Id.; see also I.R.C. § 884(f) (2012).
182. U.S. REAL ESTATE FUNDS AND FIRPTA, supra note 135, at 6; see also I.R.C. §884(f).
treaty with the United States which provides for a 0% withholding on in-
terest, or are non-U.S. governments.

Leveraged blockers have many potential structural problems. First,
although it is tax efficient, it is not best for short-term investments be-
cause it “could be an expensive and complex structure to establish and
organize.” Although the expenses can be recouped during the invest-
ment stage, the investment horizon must be adequate to overcome the
hurdle rate. Short-term investments require too high of a barrier. For ex-
ample, typical private equity investors base their valuations on an inter-
nal rate of return (“IRR”). This IRR is essentially the likelihood that a
company will be larger, more profitable, and therefore more valuable at
the time of exit. A private equity investor will have a target IRR of
25% to 35% over their four- to seven-year investment horizon. There-
fore, if the initial costs are high and the time horizon is short, the asset
must appreciate at an accelerated level. Otherwise, the structure will not
be utilitarian.

3. Variations on the Leveraged Structure

There are multiple versions or one-oﬀs of the leveraged structure.
For example, there are parallel funds, series partnerships, or a combina-
tion of all. A parallel fund structure is designed for real estate funds with
a global portfolio. To avoid subjecting the non-U.S. holdings to U.S.
taxation, a variation of the leveraged blocker structure is required. There
would be two parallel funds to isolate the U.S. and non-U.S. invest-
ments.

183. See Peter H. Blessing, The Branch Tax, 40 TAX LAW. 587, 630 (1987). For example, Austria,
Belgium, and Denmark all have no withholding. U.S. REAL ESTATE FUNDS AND FIRPTA, supra note
135, at 19 n.6.
184. U.S. REAL ESTATE FUNDS AND FIRPTA, supra note 135, at 6. There are a number of other
mixes: (1) “Non-U.S. investors that are not residents of a jurisdiction that has a tax treaty with the
United States, each of whom holds less than 10% of the Leveraged Blocker;” (2) A combination of
(1) and for example; (3) “A market-based debt to equity ratio sufficient to maximize the effectiveness
of the leverage, taking into account property-level debt (perhaps 50%–75% leverage);” (4) “A rea-
sonable interest rate on the debt that takes into account (among other things) creditworthiness and
type of cash ﬂow from the underlying real estate assets;” and (5) “Non-U.S. investors who reside in a
jurisdiction that has a tax treaty with the United States to take advantage of reduced withholding rates
on dividends.” Id.
185. Id.
186. See Oliver Gottschalg & Ludovic Phalippou, The Truth About Private Equity Investment, HARV.
formance/ar/1.
187. Id.
188. Paul Gompers et al., What Do Private Equity Firms Say They Do? 16–18 (Harvard Bus. Re-
189. U.S. REAL ESTATE FUNDS AND FIRPTA, supra note 135, at 11; see also Oscar Teunissen &
Joni Geuther, Infrastructure Investing: Global Trends and Tax Considerations, 20 J. INT’L TAX. 38, 41
(2009).
Further, to maximize the tax efficiencies for non-U.S. investors, series partnerships could be employed. If a structure could be used to allow for the exit of the investment as a liquidating distribution rather than a dividend, there is no withholding tax and no tax at all. Under the leveraged blocker technique, however, the “[i]nvestors’ interests in a private equity fund are part of a pooled approach, and not generally made on an investment-by-investment basis, at least vis-à-vis other investors.” In Delaware, a series partnership can be separate pools. There would be a series of partnership units in which the non-U.S. investors would contribute through different blockers. Further, the U.S. investors would invest in a separate parallel partnership.

Each partnership would then invest side-by-side in the assets. There would be as many series and blockers as invested assets. “When the fund disposes of a real estate investment, it distributes the proceeds to the holder of the series to which that investment relates.” “The non-U.S. investors are repaid on their investment through debt repayment—like the Leveraged Blocking structures previously discussed—and through a liquidating distribution of the relevant blocking entity.”

Given that “the blocking entity at that time only holds cash from disposal of the real estate investment to which it relates and not an interest in the other real estate investments held by the partnership (on the theory that each series is truly separate and distinct), the liquidating distribution theoretically would trigger no U.S. tax.” The series structure is not common, mostly because there is no ruling on treating the series partnership as a separate entity. Thus, the use of the structure increases not only the reward, no taxation, but the risk. If the entity were not respected, the result would be FIRPTA imposition.

191. Id.; see also Treas. Reg. 301.7701-1 to -3 (as amended in 2011, 2012, and 2006, respectively) (establishing the difference between a partnership and corporation for federal tax purposes); Thomas M. Stephens & Marc L. Schultz, Segregating Assets Within a Single Partnership: Delaware Series Partnerships and LLCs, 78 TAXES 231, 233 (2000). It should be noted that series partnerships sound much better than they actually are. They have significant downside in the raising of debt financing as well as structured exits of partners. They generally do not provide any benefits that are not available in single-asset private REITs. See, e.g., Chester W. Grudzinski, Jr., U.S. Oil and Gas Interests, Foreign Investors, and FIRPTA, 41 REAL ESTATE TAX’N 113, 127 (2014). Most practitioners utilize the series partnership structure out of fear of qualifying a REIT. See id.


193. Id.

194. Id. at 12.

195. Id. at 12; see also Susan Kalinka, Assignment of an Interest in a Limited Liability Company and the Assignment of Income, 64 U. CIN. L. REV. 443, 467–69 (2009).


197. Id. at 13.
There are many options for pooled investment in real property. The most common fractional ownership structures include traditional corporate structures to tenancy-in-common ("TIC") partnerships. The primary limitation to most structures is the limited ability for pooling of small investors in multiple properties. TICs, for example, are great for single property acquisition but do not allow multi-property risk spreading. REITs were specifically designed to allow small investors to diversify their risk in a pool of properties. If a traditional corporate structure meets the specific requirements of the REIT rules, it can elect to be treated as a REIT. REIT status allows the corporation to deduct dividends paid to shareholders, avoiding the traditional double taxation of a corporation. “To qualify for this special treatment, a REIT must distribute at least 90% of its net income exclusive of capital gains to its shareholders.”

This section will discuss the general REIT rules. Once those rules are examined, a key deficiency of the REIT rules will be exposed. Specifically, the rules related to REITs only require that a REIT have at least 100 holders of beneficial interests, but that rule does not require those shareholders have a significant equity stake. The ability to use so-called "accommodation shareholders" allows for private REITs. For foreign investors not issuing shares of the REIT as a public allows the advantageous tax benefits without the onerous securities rules.

198. See, e.g., Lenín E. López, A Matter of Semantics: Should Tenancies-in-Common Be Treated as Securities or Real Estate Interests?, 8 J. BUS. & SEC. L. 1, 2 (2007) (“The average investor does not have the capital necessary to individually purchase a 30 million dollar office park. Within the past 10 years the tenant-in-common model of ownership has allowed a number of individual investors to own an undivided fractionalized interest in commercial real estate and also defer recognizing capital gains from the sale of other investment property.”); Bradford Updike, Exploring the Frontier of Non-Traditional Real Estate Investments: A Closer Look at 1031 Tenancy-in-Common Arrangements, 40 CREIGHTON L. REV. 271, 273 (2007) (“Additionally, TICs can provide an opportunity to own a piece of a high-grade commercial investment, which might not otherwise have been available through a direct purchase.”).

199. See Treas. Reg. § 1.897-1(c)(2)(i) (1984). For purposes of this determination the actual owners of the stock, as determined under Treas. Reg. § 1.857-8 (as amended in 1981), must be taken into account. The determination date is the date of disposition or any other determination date described in Treas. Reg. § 1.897-2(c) (as amended in 2016). BYRNES, HERZIG, & SOVE, supra note 45, § 45:55; Brown, supra note 33, at 311–12.


202. DELLOITTE, TAXATION OF FOREIGN INVESTMENT, supra note 201, at 8; see also Treas. Reg. § 1.897-1(c)(2)(i) (as amended in 2003).

203. Taylor, Blockers, supra note 2, at 10–11.


205. Taylor, Blockers, supra note 2, at 10.
There are three main requirements for a corporation to qualify as a REIT. The broad categories are (1) ownership (at least 100 beneficial owners, “and no five or fewer individuals may own directly or indirectly more than 50% of the total value of the REIT stock”);206 (2) assets (“at least 75% of the total value of the REIT’s assets must consist of cash, real estate, loans secured by real estate, or U.S. government securities”);207 and (3) income (“at least 95% of the REIT’s gross income must be composed of interest, dividends, and rents from real property, plus six other specified sources of income”).208 There is a final restriction on the type of income that qualifies. Since the entity exemption is tied to real estate, there is a restriction that “at least 75% of a REIT’s assets must consist of real estate assets, cash and cash items, and government securities.”209

There are some key components in the structure of REITs. In order to qualify as a REIT, a corporation either has to elect REIT status upon formation or be an existing U.S. corporation that reorganizes as a REIT. In order to do this, “[e]xisting U.S. corporations that wish to elect REIT status must distribute all pre-election earnings and profits for tax years accumulated after February 28, 1986.”210 There are many ways to avoid tax at the corporate level in such a reorganization. Most often, the corporation distributes “all net income currently to shareholders thereby eliminating the normal double taxation of corporate income.”211 Fortunately, since a REIT is treated the same as any other U.S. corporation, they will have the same exemption from the branch profits tax (“BPT”). Thus, the BPT will not impose a second level of U.S. taxation on the REIT.212 Finally, in order to limit liabilities, a REIT structure often utilizes subsidiaries for individual projects. “REITs are permitted to have 100% owned subsidiaries, each of which are essentially treated as disregarded entities for income tax purposes.”213

There are certain tax implications for foreign investors in a REIT.214 Since the REIT election is elective and distorts the traditional taxation of corporate dividends, there will be a series of restrictions on distributions. I will discuss the results cascading from distributions to sale of REIT interests. First, I will address distributions and describe the “look through”

206. Deloitte, Taxation of Foreign Investment, supra note 201, at 8; see also I.R.C. § 897(b)(1).
207. I.R.C. § 856(c)(4)(A).
208. Id. § 856(c)(2).
209. Bradley T. Borden, Reforming REIT Taxation (Or Not), 53 Hous. L. Rev. 1, 23 (2015); see also I.R.C. § 856(c)(3).
212. See Brown, supra note 33, at 326.
rule that applies with REITs. Then, I will discuss the consequences of sales of the REIT shares.

If a distribution is tied to the sale or exchange of a U.S. real property interest, the corporate form will be ignored and then the gain will be taxed as effectively connected income ("ECI"). The ECI designation will result in income tax for the foreign person with the source as a U.S. trade or business.

As we recall, FIRPTA only applies to distributions that are capital gain. Since most sales are ECI and ordinary, then the FIRPTA rules generally do not apply. The downside to this treatment is that many non-U.S. persons and corporations may be tax-exempt as related to capital gain property. The recharacterization of income as ordinary may avoid the FIRPTA withholding, but at the expense of increasing the tax burden. This trade-off has complicated planning. It also causes secondary planning, such as using “a U.S. partnership to invest in the REIT [which] may mitigate potential over-withholding for noncorporate investors.”

But in the private REIT setting, this restriction will not be an issue.

A key element of U.S. tax treaties is they may not be used to reduce the total tax obligations related to FIRPTA or the mandatory withholding. The backstop to this rule is that foreign investors which have incorporated may also be subject to a 30% BPT. The ECI designation then causes the second order problem of additional reporting. Since ECI is ordinary income, the foreign investor would be required to file a U.S. income tax return.

One exception to this rule is the 5% rule. If the REIT is publicly traded, then the U.S. real property interest will not be treated as ECI and as ordinary if the foreign investor owns less than 5% of such class of stock. This reverses the look-through treatment under the default rule. The distribution to the foreign investor will be an ordinary dividend as

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any other stock dividend and as such not subject to FIRPTA. The genesis
of the dividend proceeds, e.g., real estate, is no longer important.224

Consistent with the look-through treatment, to the extent that the
REIT makes distributions of an interest that is not classified as a U.S. re-
al property interest (e.g., non-FIRPTA mortgage loans or non-U.S. real
property), the distribution will retain the attributes it had as capital gain
and not ECI.225 Although some have argued that the statute and regula-
tions may be in conflict, “the most commonly accepted view by practi-
tioners is that the REIT would also not be required to withhold on such
designated capital gain distributions.226

Because FIRPTA creates a look-through to the underlying assets of
the entity, all distributions must be examined under the same lens. For
example, traditional returns of capital must be viewed to ensure there is
not a FIRPTA withholding requirement.227 Unless there is an exception
under Section 897,228 the REIT is not required to withhold on distribu-
tions paid to foreign persons.229 If an applicable exception is unavailable,
then there is an additional 10% withholding tax under the FIRPTA
rules.230 The withholding tax would then require the filing of a U.S. tax
return to claim a refund.231 This would then subject the foreign person to
IRS supervision. Finally, the back-up BPT would not apply on basis re-
turn qualifying distributions.232

The final way that an investor of a REIT could have its capital re-
turned is through the sale of the interest. FIRPTA, generally, subjects
sale of the REIT interest as subject to U.S. tax.233 Under the recharacteri-
zation rules of FIRPTA, the gain on the sale of the shares would be
treated as ECI instead of capital gains also triggering the return filing ob-
ligation.234 Because the gain is ECI, it would be taxable at ordinary rates,

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224. See Lipton & McDonald, supra note 221, at 258.
226. DELOITTE, IMPACT OF FIRPTA, supra note 211, at 2; see also Staffaroni, supra note 214, at
553–54.
227. I.R.C. §§ 301(c)(2), (3)(A); see also DELOITTE, IMPACT OF FIRPTA, supra note 211, at 3
(“Distributions . . . in excess of the REIT’s current or accumulated earnings and profits would gener-
ally be a nontaxable return of capital to the extent of a foreign investor’s tax basis in the REIT.”).
228. This generally means that less than 50 percent or more in value of the REIT stock is directly
or indirectly held by foreign investors for a period of five years. See I.R.C. § 897.
229. Staffaroni, supra note 214, at 568; Taylor, Blockers, supra note 2, at 5.
230. I.R.C. § 1445. Withholding does not excuse the foreign transferor from filing a U.S. income
tax return, but the tax withheld is credited against the transferor’s U.S. tax liability. Treas. Reg.
§ 1.1445-1(f) (as amended in 2016). At the taxpayer’s request, the Service may in certain circumstances
reduce the amount required to be withheld. I.R.C. § 1445(c); Treas. Reg. §§ 1.1445-3, -6 (as amended
in 2016). Special rules apply to distributions by certain pass-through entities. I.R.C. § 1445(c)(1);
Treas. Reg. § 1.1445-5(c) (as amended in 2016).
231. Id.
232. I.R.C. § 884(d)(1); Temp. Reg. § 1.884-1T(f)(1); see also Fred Feingold & Mark E. Berg,
Whither the Branches, 44 Tax L. Rev. 205, 211 (1987).
233. Taylor, Blockers, supra note 2, at 5; see also DELOITTE, IMPACT OF FIRPTA, supra note 211,
at 15 (providing that most REITs are subject to FIRPTA because other than mortgage REITs, most
REITs are U.S. RPHCs).
234. Taylor, Blockers, supra note 2, at 5. Also, the return filing opens up the IRS investigatory
powers.
i.e. 35% to corporate foreign investors. Obviously, this is higher than the capital gain rates if it was not recast as ECI. Investors can avoid the ECI rule if the REIT is either controlled by U.S. persons or if the REIT is publicly traded (the 5% Public Exception).

Foreign investors can continue to game the rules by strategically avoiding the ECI applications. For example, an investor may be able to reduce the impact of FIRPTA by avoiding ECI through investment in domestically controlled REITs and publicly traded REITs. Industry leaders advocate for avoidance through “purchasing shares in REITs controlled by U.S. shareholders.” Foreign persons owe no FIRPTA taxes for the sale of domestically controlled REITs. Under the rules, as discussed infra, generally, the threshold is foreign persons owning less than 50% of the value of a REIT. The application of FIRPTA does not change the taxability of the distributions, only the FIRPTA requirements. Another option, advocated by industry, is to utilize the publicly traded REIT exemption—as long as the foreign person owns less than 50 percent of the value of a REIT for the lesser of 5 years or the time during which the REIT has been in existence.

So, do REITs work? A general REIT has limited applicability because the domestic control requirement limits the investment to 49%. That limitation might not provide enough equity in the U.S. real estate market. Because there is a limit to the leverage a REIT can employ to acquire real estate within the IRR parameters, public REITs have size limitations. Therefore, the public REIT exception (5%) might be too small. The use of accommodating parties to create a private domestic controlled REIT has moved to the forefront.

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235. I.R.C. § 897(a).
236. Staffaroni, supra note 214, at 529, 535.
237. DELOITTE, TAXATION OF FOREIGN INVESTMENT, supra note 201, at 2.
238. DELOITTE, IMPACT OF FIRPTA, supra note 211, at 4.
239. I.R.C. § 897(h)(2); see also Staffaroni, supra note 214, at 547, 563.
240. DELOITTE, IMPACT OF FIRPTA, supra note 211, at 4. Congress has continually considered increasing the 5% exemption to 10%. See Staffaroni, supra note 214, at 562.
241. Id.
242. See, e.g., Bradley T. Borden, Rethinking the Tax-Revenue Effect of REIT Taxation, 17 FLA. TAX REV. 527, 605 (2015) (“Private REITs generally must ensure that they are domestically controlled to avoid causing foreign investors to lose treaty benefits; otherwise, foreign investors will simply acquire interests in publicly traded REITs.”); Jonathan L. Funk & Scott A. Mclaughlin, Please Dispose Properly—Tax Issues and Potential Pitfalls In Disposing of Private REITs, 42 REAL EST. TAX’N 93, 93 (2015) (“Private REITs have become more prevalent in recent years . . . .”); Joseph G. Howe, III, Clinton Administration Renews Its Attack on Private Reits: Notwithstanding the Clinton Administration’s Proposal, Investments in REITs Continue to Offer Tax Planning Opportunities, 2 No. 3 BUS. ENTITIES 26 (2000); Taylor, Blockers, supra note 2, at 10 (“There is a significant publicly traded REIT industry, but there are many more, by number, private REITs . . . .”).
D. Direct Investment

FIRPTA clearly applies to direct investment in a U.S. real property interest (as defined by the Code). The only issue related to a direct investment analysis is if the U.S. property is not owned in fee simple. For example, if a foreign investor owned a building in the United States that it net leased, the rentals would be U.S. source income. To be subject to the 30% withholding requirement and the IRS powers of FIRPTA, the foreign investor must not be treated as engaged in a U.S. trade or business by reason of such investment. The gross rental income (with no deductions for depreciation, interest, or other expenses) would be subject to FIRPTA. This generally could not be reduced under tax treaties.

Alternatively, if the U.S. real estate investment were treated as a U.S. trade or business, the investor would be required to file U.S. tax returns and would be subject to U.S. tax at the regular corporate or individual tax rates on the net income from the investment. Moreover, a foreign corporation can be subject to the BPT. Regardless, the foreign investor would be taxable under FIRPTA upon the sale of the U.S. real estate assets.

IV. Justifying FIRPTA Using International Tax Rules

Before 1980, a foreign investor took advantage of international treaties and tax rules to avoid U.S. taxation. After FIRPTA, investors were forced to confront not only traditional international tax principals, but also, a seemingly contrarian rule for real property. To understand the
structuring investors utilized and if FIRPTA should be retained, it is necessary to examine the rules that FIRPTA altered.

Most often, investors employed the strategy of realizing the gain in a company’s real estate holdings by selling the stock of that company rather than having the company sell its assets. Generally, the company was engaged in a “trade or business,” e.g., managing the property, while the investor was not.250 “The investor’s gain, therefore, was usually tax-free. Now, however, that gain is taxable, because FIRPTA treats the stock of companies that own real estate as “real property interests.””251

There were in force a number of treaties that exempted from tax all capital gains not attributable to a permanent establishment conducting a U.S. trade or business.252 Thus, where gains from real estate investments were not so related, the treaty prohibited the imposition of a U.S. income tax.253 FIRPTA was obviously a violation of such treaty provisions. In enacting FIRPTA, however, Congress provided that prior existing treaty obligations were to be respected for four years, thereby allowing the Treasury department time to renegotiate treaties whose terms were inconsistent with the requirements of FIRPTA.254

Many tax treaties exempt from U.S. taxation any capital gains realized by residents of the other signatory country.255 Although these provisions typically exclude real estate gains from their protection, they do apply to gains from the disposition of corporate stock.256 Thus, there is a rather direct confrontation between the treaty capital gain exemptions and FIRPTA’s treatment of real estate company stock.

Under U.S. practice, Congress has the power to effectively override treaty provisions.257 If Congress enacts a statute that is inconsistent with an existing treaty, U.S. courts will apply the statute so that the treaty

250. Stock ownership itself does not constitute a trade or business.
251. Kaplan, supra note 11, at 1110.
253. Kaplan, supra note 11, at 1110.
255. See supra note 252 and accompanying text.
256. German Treaty, supra note 252, at arts. IX(1), IXA(1); Netherlands Treaty, supra note 252, at art. XI; Norwegian Treaty, supra note 252, at art. 12(1)(a); see also TREASURY REPORT, supra note 26, at 39–40.
257. See, e.g., Whitney v. Robertson, 124 U.S. 190, 194 (1888).
benefits will be effectively denied.258 This practice is generally characterized as the “later-in-time doctrine.”259 The practice is upheld even though the result may be to place the United States (as a nation-state) in violation of the treaty. Section 7852(d)(1) of the Code reflects this practice in the tax area: “For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.”260

New legislation does not, however, always replace contrary treaty provisions. Congress will sometimes make it clear that new legislation is not intended to terminate existing treaty benefits. Legislative overrides of income tax treaties, however, have occurred on a number of occasions in recent decades and remain a source of concern to treaty partners.261

A. Source Rules

FIRPTA section 1124 amended section 861(a)(5) of the Code to tie the source of gain from the sale of real property to the definition of a “United States real property interest” in section 897(c) of the Code.262 Before this amendment, the source of gain from the sale of real property was determined solely by reference to the location of the real property sold. Former section 861(a)(5) treated gain from the sale of real property located in the United States as U.S. source income.263 Section 862(a)(5) still refers to the location of the real property sold in stating that gain from the sale of real property located in a foreign country is foreign-source income.264

Unlike most other U.S. source capital gains—which are generally not taxed to a foreign investor—FIRPTA subjects gain or loss of a foreign person from the disposition of a U.S. real property interest to tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or
business.\textsuperscript{265} In addition to an interest in real property located in the United States or the Virgin Islands, USRPIs include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a five-year period ending on the date of the disposition of the interest, a U.S. RPHC (which is defined generally to mean any corporation the fair market value of whose U.S. real property interests equals or exceeds 50% of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).\textsuperscript{266}

Distributions by a REIT to its foreign shareholders attributable to the sale of USRPIs are generally treated as income from the sale of USRPIs.\textsuperscript{267} Such distributions are subject to 35% withholding.\textsuperscript{268} There is an exception that essentially subsumes the rule. In the event a REIT is regularly traded on an established securities market located in the United States, then a distribution by a REIT to a foreign shareholder that has not held more than 5% of the stock of the REIT for the one year period ending with the date of the distribution is withheld at a 30% or lower rate.\textsuperscript{269}

A different rule applies for regulated investment companies ("RICs"). For years 2005, 2006, and 2007, any RIC distribution to a foreign shareholder attributable to the sale of USRPIs is treated as FIRPTA income, without any exceptions.\textsuperscript{270} No Treasury regulations have been issued, however, addressing withholding obligations with respect to such distributions.

The law thus provides rules for taxing foreign persons under FIRPTA on distributions of gain from the sale of USRPIs by RICs or REITs. Some taxpayers, however, attempt to avoid this rule by investing in a RIC or REIT that, in turn, invests in a lower-tier RIC or REIT that is the entity that disposes of USRPIs and distributes the proceeds. This would then mean that the proceeds from such disposition by the lower-tier RIC or REIT would cease to be FIRPTA income when distributed to the upper-tier RIC or REIT (which is not itself a foreign person). The ultimate result is that the distributable amount may be distributed by that latter entity to its foreign shareholders as non-FIRPTA income of such RIC or REIT, rather than continuing to be categorized as FIRPTA income. Furthermore, RICs may take the position that in the absence of regulations or a specific statutory rule addressing the withholding rules for FIRPTA capital gain that is treated as effectively connected with a

\textsuperscript{265} I.R.C. § 897.
\textsuperscript{266} Id.
\textsuperscript{267} Id. § 897(h)(1).
\textsuperscript{268} Treas. Reg. § 1.1445-8(c)(2) (as amended in 1995).
\textsuperscript{269} In such cases, the REIT and the shareholder treat the distribution to a foreign shareholder as the distribution of an ordinary dividend, subject to the 30% (or lower treaty rate) withholding applicable to dividends. I.R.C. §§ 857(b)(3)(F), 897(h)(1).
\textsuperscript{270} Taylor, Blockers, supra note 2, at 15.
U.S. trade or business, such gain should be considered capital gain for which no withholding is required.\textsuperscript{271}

In addition, some foreign persons may be attempting to avoid FIRPTA tax on a distribution from a RIC or a REIT by selling the RIC or REIT stock shortly before the distribution and buying back the stock shortly after the distribution.\textsuperscript{272} If the stock were not a USRPI in the hands of the foreign seller, that person would take the position that the gain on the sale of the stock is capital gain not subject to U.S. tax.\textsuperscript{273} Stock of a RIC or REIT that is “domestically controlled” is not a USRPI.\textsuperscript{274} If the stock is a USRPI in the hands of the foreign person, the transferee generally is required to withhold 10\% of the gross sales price under general FIRPTA withholding rules.\textsuperscript{275}

\section*{B. Effectively Connected}

FIRPTA radically changed the accepted definitions for “effectively connected” and “trade or business” and the treaties the U.S. entered into, especially those before 1980. These distortions may be permissible if a sovereign has a superior right to tax real property other than investments. If not, then FIRPTA should not be permissible.

\subsection*{1. General Principles}

The power to tax is an essential attribute of sovereignty because it is a necessary instrument of self-government and territorial management.\textsuperscript{276}

\begin{footnotesize}
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\item \textsuperscript{271} Id. at 10.
\item \textsuperscript{272} Id. at 12.
\item \textsuperscript{273} See I.R.C. §§ 897(c)(1)(A)(ii), 1445(b)(2)–(3); see also Treas. Reg. § 1.897-1(c)(ii) (as amended in 2003); Treas. Reg. § 1.897-2(g)(1)(i) (as amended in 2003) (flush language); Treas. Reg. § 1.1445-2(c)(3) (as amended in 2003).
\item \textsuperscript{274} I.R.C. § 897(b)(2). A RIC or REIT is “domestically controlled” if less than 50\% in value of the entity’s stock is held by foreign persons. RIC stock ceases to be eligible for this exception as of the end of 2007. Distributions by a domestically controlled RIC or REIT, if attributable to the sale of U.S. real property interests, are not exempt from FIRPTA by reason of such domestic control. A foreign person that would be subject to FIRPTA on receipt of a distribution from such an entity might sell its stock before the distribution and repurchase stock after the distribution in an attempt to avoid FIRPTA consequences. Under a different exception from FIRPTA, applicable to stock of all entities, neither RIC nor REIT stock is a U.S. real property interest if stock is regularly traded on an established securities market located in the United States and if the stock sale is made by a foreign shareholder that has not owned more than 5\% of the stock during the five years ending with the date of the sale. I.R.C. § 897(c)(3). Distributions by a REIT to a foreign person attributable to the sale of U.S. real property interests are also not subject to FIRPTA if made with respect to stock that is regularly traded on an established securities market located in the United States and made to a foreign person that has not held more than 5\% of the REIT stock for the one-year period ending on the date of distribution. I.R.C. § 897(b)(1). Thus, any foreign shareholder of such a regularly traded REIT that would be exempt from FIRPTA on a sale of the REIT stock immediately before a distribution would also generally be exempt from FIRPTA on a distribution from the REIT if such shareholder held the stock through the date of the distribution, due to the holding period requirements. Distributions that are not subject to FIRPTA under this 5\% exception are re-characterized as ordinary dividends and thus would normally be subject to ordinary dividend withholding rules. I.R.C. §§ 857(b)(3)(F), 1441.
\item \textsuperscript{275} I.R.C. §§ 1445(a), (c).
\item \textsuperscript{276} See Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 137 (1982) (making the assertion related to Indian Tribes).
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\end{footnotesize}
This power enables a government to raise revenues for its essential services.277 The sovereign has general authority to control economic activity within its jurisdiction and to defray the cost of providing governmental services by requiring contributions from persons or enterprises engaged in economic activities within that jurisdiction.

The United States reduces U.S. taxation only on inbound foreign investors, while the foreign country reduces its taxes only on U.S. persons investing there. One motivation for this rule, referred to as a “saving clause,” is that the U.S. Congress designs U.S. tax policy in the first instance, where all revenue bills are required by the Constitution to originate with the House of Representatives.278 A treaty, on the other hand, is negotiated and signed by the Executive Branch subject to the approval of the Senate.279 Thus, the House Committee on Ways and Means, which is the primary architect of the tax policy embodied in the Code, has no official involvement in the tax treaty process. The constitutional tension between tax legislative policy and tax treaty policy as applied to U.S. persons is alleviated by the U.S. treaty policy of generally not providing benefits of U.S. tax treaties to U.S. citizens, residents or companies.280

All countries’ sovereignty, including that of the United States, creates the right to tax the income that arises within its borders.281 Once it is established that the United States may tax citizens of other countries, there are two specific tax regimes that the United States utilizes to tax those foreign individuals.282 These two regimes depend on the nature of the income earned. If the income is active, e.g., profit from an active business in the United States, then that income is taxed at standard rates.283 This active income is known as income effectively connected with a U.S. trade or business. The other type of income earned is passive income. This is known as fixed or determinable annual or periodical (“FDAP”) income and is taxed at a flat rate of 30%, generally with no allowance for deductions.284

There are two main taxation events for real property. First, there are the yearly investment profits, such as leasing receipts or receipts from

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279. Kirsch, supra note 278, at 1090.
280. Id.
282. When a foreigner becomes a fiscal resident, such as through the presence of a permanent establishment, a country may impose graduated tax rates on income. In such a situation, governments allow deductions for expenses (depreciation, interest, and administrative expenses) related to the property. In some instances, however, the deductions may be limited to a specified percentage of income or computed on an estimated, rather than on an actual, basis.
283. Normal deductions are also allowed. See I.R.C. §§ 871(b), 882(a), 884; Knoll, supra note 13, at 710.
284. I.R.C. §§ 871(a), 881; Knoll, supra note 13, at 710.
property rights. Second, are the capital gains on appreciation upon sale of the property. Governments generally impose withholding taxes at flat rates on the gross payment, with the tax rate subject to change when a tax treaty between the host country and the nonresident’s home country is applicable.

2. Real Property is Special

From a treaty perspective, real property is different. Property rights are derived from the sovereign. Through its function as a sovereign, any federal, state, or local governmental entity may acquire ownership of real property through bankruptcy, tax delinquency, abandonment, escheat, eminent domain, condemnation, or any circumstance in which the government entity involuntarily acquires title.

American legal doctrine has always recognized that the sovereign has an inherent power of eminent domain. That is defined as the power “of taking or of authorizing the taking of any property within its jurisdiction for the public good.” This premise is such that all constitutional provisions addressing eminent domain are couched in terms of limitations on the power and not in terms of the grant of the power in the first place. The predominance of this early view of the eminent domain power as being inherent within the sovereign led the courts to make determinations which were consistent and constrained.

286. Id. at 713.
287. There are also state level taxes. A country may tax nonresidents on income from real property through withholding; the state collects the tax at the source of payment with the lessor becoming a withholding agent who withholds an amount to pay the income tax.
289. According to the U.S. Supreme Court’s classic statement, the taking power is a “political necessity” because “[s]uch an authority is essential to [the sovereign’s] independent existence and perpetuity,” Kohl v. U.S., 91 U.S. 367, 371 (1875); see also 1 JOHN LEWIS, A TREATISE ON THE LAW OF EMINENT DOMAIN IN THE UNITED STATES 7, 672 (3d ed. 1917); Abraham Bell, Private Takings, 76 U. CHI. L. REV. 517, 526 (2009).
291. U.S. CONST., amend. V (“[N]or shall private property be taken for public use, without just compensation.”). None of the early state constitutions explicitly granted the power of eminent domain to the states. See Nichols, supra note 290, at 58 (“The provisions found in most of the state constitutions relating to the taking of property for the public use therefore do not by implication grant the power of eminent domain to the government of the state, but they limit a power already existing which would otherwise be unlimited.”). Even the Fifth Amendment is phrased in terms of a restraint upon a power that is nowhere explicitly granted to the federal government. See ELLEN FRANKEL PAUL, PROPERTY RIGHTS AND EMINENT DOMAIN 73–77 (1987) (discussing the adoption of the Fifth Amendment); William Michael Treanor, Note, The Origins and Original Significance of the Just Compensation Clause of the Fifth Amendment, 94 YALE L.J. 694 (1985) (discussing the adoption and ratification of the Fifth Amendment).
There is further evidence that U.S. real property is truly under the dominion of the sovereign. The government has blocked the acquisition of U.S. real property on the basis of national security. 292 Treasury issued regulations in 2008 explicitly including the acquisition of U.S. real estate in the definition of “covered transactions” that may possibly require pre-closing review by the federal government’s fourteen-member, inter-agency Committee on Foreign Investment in the United States (“CFIUS”). 293

The CFIUS regulations are an outgrowth of the Foreign Investment and National Security Act of 2007 (“FINSA”). 294 “Under Exon-Florio, the President is authorized to suspend, prohibit, or reverse any transaction that might result in foreign control of a U.S. business if national security interests would be impaired.” 295

Although the United States, as sovereign, has the ability to take real property and stop the sale of real property, it does not have a special power to tax the land in the form of a property tax. 296 Although the United States has had a property tax—the Federal Property Tax Act of 1798—these first taxes were abolished in 1802. 297 Moreover, in 1913, Congress passed the 16th Amendment. 298 The 16th Amendment stopped direct taxation. 299
V. MOVING TO A COHERENT CONCEPT OF FIRPTA

Tax evasion is a fundamental problem. Combating evasion is difficult. As soon as rules are implemented, advisors begin the arduous task of planning around the rules. This give and take can be seen through the development of the rules associated with foreign investors holding U.S. real estate. Before the adoption of section 871, there was no tax on nonresident aliens. Then the United States decided that there should be a more equal playing field and adopted section 871. As detailed in the Treasury Report, as soon as the provision was passed, investors started employing a laundry list of structures to avoid the application of those rules. Then Congress responded with the adoption of FIRPTA in 1980. FIRPTA was intended to stop the post section 871 abuses. As clearly detailed in Part III, however, there are numerous easy ways to avoid the application of FIRPTA. Any new legislation would merely result in more and more structuring.

By allowing tax rules to be arbitraged, the United States has become a tax haven for foreign investors. The most prudent course Congress could take is to effectively capture the leakage rather than accept the minimal impact of FIRPTA’s current elective form. To accomplish this, Congress should expand the scope of FIRPTA to make it more efficient. A net income tax regime with backup withholding should replace the gross income tax regime such as FIRPTA. The first step is to implement a change in FIRPTA to impose FATCA regulations. This would alter FIRPTA to provide a complete look-through rule and then follow the FATCA regime of information reporting and withholding.

A. Real Property is Always Source

Under the standard source rules in international tax, it would seem incongruous to have differing rules for the sale of all other capital assets other than real property as FIRPTA does. It would seem to appear that all capital assets should be treated equally. Prior to the enactment of

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300. See, e.g., Ring, supra note 19, at 126 ("Another explanation may be the recognition that the 'unelegant' version is quite convoluted to attack and by its very nature limited in scope. The elegant version, with presumably fewer steps and lower transaction costs, poses a much greater risk and may reasonably be singled out for attack. Of course, this assessment may not be factually accurate in every case; it is possible that stopping the easy version and forcing taxpayers to pursue the more complicated tax planning options ultimately causes more harm due to the deadweight loss."); Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 GEO. L. J. 543, 544 (2001).
301. See Ring, supra note 19, at 126--27.
302. Taylor, Blockers, supra note 2, at 7.
303. Fleischer, supra note 11, at 462; Kaplan, supra note 11, at 1092--98; Knoll, supra note 13, at 703.
304. TREASURY REPORT, supra note 26, at 45.
305. Id. at 11.
306. See supra notes 249--53 and accompanying text.
307. Brown, supra note 33, at 300; Fleischer, supra note 11, at 491--92; Taylor, Blockers, supra note 2, at 7--8.
FIRPTA, foreign investors structured U.S. transactions to obtain the benefits of ownership as capital.308

Clearly owning real property in a source country would subject that property to the standard source rules.309 The second order problem occurs once that ownership structure is changed (e.g. a stream of income derived from that underlying property should there be a look-through type rule). This rule would allow the source country to tax the revenue derived from the underlying real property even if the form is changed.

The source of a foreign investor’s investment income is a critical component in determining its U.S. taxability. Generally, foreign investors are subject to U.S. tax on income effectively connected with a trade or business in the United States, regardless of the source of the income.310 With respect to all other kinds of income, tax is paid only on U.S. source income.

FIRPTA altered these general rules by expanding the capture of source income to not only the underlying real estate, but also to the entity that holds the property.311 A USRPI is defined to include a corporation (real property holding corporation, or RPHC) whose assets are more than 50% comprised of USRPIs.312 For example, if a foreign investor owned stock in a U.S. corporation whose principal assets were real property located in the United States, gain on the sale of such stock would be subject to the FIRPTA rules.313

Real property, however, has special characteristics that make the right of the sovereign to tax it superior to other countries. This can be seen both from the way the property is owned and the exemption in current income tax treaties.314 Unlike the source rules for capital gains, real property is inherently different in nature, as it is immovable, and the standard source rules should not apply. This premise then must extend to all manners in which profits are derived from the underlying property. It is not adequate to allow the form the property is held to be the determinative factor.

Rather than relying on these fundamentals, when FIRPTA was enacted the primary goal was a xenophobic view of the world where the narrative suggested that the United States should protect its assets from

308. TREASURY REPORT, supra note 26, at 11.
310. I.R.C. §§ 873(a), 882(c) (2012).
311. Brown, supra note 33, at 300; Fleischer, supra note 11, at 491–92; Taylor, Blockers, supra note 2, at 9.
312. Brown, supra note 33, at 311–12 (citing I.R.C. § 897(c)(2)).
313. Id. (citing I.R.C. § 897(c)(1)(A)(ii)).
foreign ownership. Much has changed since the enactment of FIRPTA, however. The world has flattened much since the 1980s. With the globalization that has happened in the last thirty years, there has been a decline in xenophobia as well as an increased amount of cross-border investment. This has lead to even more resources dedicated to sophisticated investment structures that maximize the revenues.

It is interesting, however, that although the FIRPTA rules had nefarious roots, the premise of treating real property different from other like investments is well rooted in treatment by other countries. “Most notably, some countries deviate from the general rule by taxing capital gains at source under certain conditions.” France and Mexico, for instance, do that in cases where the (foreign) seller maintained substantial participation in a domestic company.” A 1964 income tax treaty between Belgium and France “specified that distribution of shares of the acquiring company pursuant to a fully domestic merger (a merger of two French or two Belgian companies) to a shareholder of the target company would not be considered as income in the country of residence of the (distributee) shareholder.” The purpose of this provision is to equalize the tax position of foreign and domestic shareholders in this bilateral context. “Other Belgian treaties denied (an otherwise granted) taxation at source right in cases of certain corporate structural changes of corporations with significant (source country) real property profits.”

By taxing the real property and any profits derived therefrom as source income, the United States is doing what all countries strive to do which is to have an equal playing field for both domestic and foreign investors. Although the initial reasons for this leveling might have been disingenuous, the result is proper. This is especially true given the unique nature of real property. Unlike other assets that are portable, real property is stationary and quite easy to account for. There is not a paper trail but real land. Treating profits derived from the real property falls within the traditional notion of the source rules.

The movement of most developed countries is to expand on the accepted practice of looking through ownership structure to the underlying real property. For example, in India, this notion was expanded to attempt to tax all indirect asset sales at source. In January 2012, “the Indian Su-

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315. Brown, supra note 33, at 301; Fleischer, supra note 11, at 491–93; Taylor, Blockers, supra note 2, at 5–6.
316. Yariv Brauner, Taxing Cross-Border Mergers & Acquisitions, 6 FLA. TAX REV. 1027, 1068 (2005). “This deviation is a lesser form of the policy mentioned above of taxing capital gains at source generally.” Id. at 1068 n.232.
317. Id. at 1068–69.
318. Id. at 1070; see Article 15(6) (a “dividends” article) which became article 15(8) after the amendments of the 1971 protocol to the treaty. Id. at 1070 n.237.
319. Id. at 1070 (citing The 1998 Belgium - Kazakhstan Income and Capital Tax Convention and Final Protocol, article 13 as amended by article 8 of the Protocol, and Article 13(4) of the 1996 Belgium-Vietnam Income and Capital Tax Treaty).
320. “The Delhi High Court has ordered the Indian Finance Ministry to investigate whether the $19 billion purchase of Cadbury by Kraft Foods in February 2010 should have resulted in a payment of Indian tax.” SULLIVAN & CROMWELL LLP, RECENT EFFORTS BY INDIA AND OTHER JURISDICTIONS
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The Supreme Court found that India had no basis to tax the sale by a non-Indian subsidiary of indirect interests in an Indian telecoms company, Hutchison Essar.321 “The Indian Tax Office argued that the gain accruing to the seller should be subject to tax in India because the gain arose from an ‘Indian source,’ and that the Dutch purchaser (a subsidiary of Vodafone) should therefore have withheld an amount in respect of Indian tax from the purchase price.”322 The Supreme Court of India disagreed on both counts.323 “A number of other countries, including India, Peru and China, have made recent changes to their laws or enforcement practices to impose capital gains tax on the indirect transfer of locally-resident companies and assets.”324 The broad-based approach taken by these countries is becoming more and more prevalent.

B. Solving Compliance—FATCA Style Reporting

If it is true that FIRPTA is well-grounded in the source rules, the question is how to enforce FIRPTA more effectively. The structuring foreign investors engage in allows them to avoid the underlying rules easily. Thus, finding an effective look-through rule would be crucial in determining the ultimate owner of the real property so that proper tax may be collected.

In a similar situation, Congress dealt with the problem of unreported ownership of foreign bank accounts. Rather than attack the offshore banking secrecy problem through legislation and the slow movement to compliance, the “political response to the offshore tax evasion scandals was swift.”325 The FATCA regime co-opted the financial institutions as tax administrators.326 The debate around FATCA was not should the fi-
financial institutions be the tax intermediary but, rather, how should they perform the role.

In the context of FATCA, requiring the financial institution to act allowed the government to target the source of the funds. Rather than focus on the taxpayer, the entity, or the structure, FATCA looked to the account.327 This is the most efficient tax structure. Rather than chase structure, the government chased the asset. Financial assets are movable, but only among financial institutions.328

In the context of FIRPTA, the asset is located in the jurisdiction.329 The asset is not movable. Much like FATCA, rather than focus on the structuring, I propose that FIRPTA should be modified to have mandatory reporting and withholding with high penalties for failure to report. This method is superior to the current withholding system. This proposal is in accord with the preference in the FATCA regime advocating for the reporting model over the withholding model.330

The ability of Treasury to implement a FATCA type rule to FIRPTA would be remarkably simple. The majority of entities that would be subject to the new reporting rules in the FIRPTA context are already subject to FATCA rules.331 For example, in the context of FATCA, “U.S. real estate funds, REITs, and joint ventures will be directly impacted by FATCA’s withholding, due diligence, and reporting requirements.”332 The new requirements “impose a heavy new compliance burden on many U.S. real estate ventures with foreign investors or foreign lenders.”333 The FATCA compliance rules extend to, among others, “any real estate fund or joint venture having a foreign investor holding its interest through a U.S. blocker corporation, REITs with foreign investors, regular C corporations with foreign institutional investors, real estate funds, and joint ventures with foreign lenders.”334

There are almost 400 pages of new FATCA regulations for these types of U.S. real estate investment vehicles.335 Failure to comply with these regulations subjects the U.S. entity to potentially severe financial

327. Id. at 334.
328. A taxpayer could always withdraw the money, but then, in order to either invest or purchase an item, disclose the source of those funds.
329. See supra Part IV.A.
330. Grinberg, supra note 325, at 334--35.
332. Id.
333. Id.
334. Id.
obligations. In order for the U.S. entities to remain compliant, the IRS has gone to extraordinary lengths to provide detailed guidance.

This proposal would be the exact opposite of the approach taken in 1984 when FIRPTA was enacted. The 1984 Act amended Section 6039C of the Code in order to repeal the information reporting requirements imposed by FIRPTA, and to impose new information reporting obligations upon foreign persons holding certain direct investments in U.S. real estate investments. The regulations under revised Section 6039C of the Code, however, have not been revised to date. Even though the 1984 Act enacted very broad withholding provisions, only restrictive provisions have been enacted. For example, the withholding provisions generally require that a person acquiring property from a foreign person withhold and pay over to the IRS 10% of the amount realized by the transferor on the disposition.

Not only are there regulations, albeit in development, there is also a logical starting point for a similar approach under FIRPTA. The striking similarity between the two problems is that structuring mechanisms allow non-compliance. Therefore, the solution to the FIRPTA problem should borrow from FATCA. This structure would allow the effective collection of the tax and proper withholding. Although there will be more requirements for the U.S. entities, they are experiencing those burdens already. This proposal merely piggybacks on the requirements existing in another context.

C. Downside to Aggressive Collection Positions

The normal downside to an aggressive tax position is the fear of retribution in the form of decreased investment in the country. Given that we are in a precarious financial situation as a country, it might not seem

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336. If a withholding agent, U.S. financial institution, or FFI fails to withhold the 30% or any other tax due, they become liable for it, plus interest and eventual penalties. See also Jeff N. Mukadi, FATCA and the Shaping of the New International Tax Order, 66 Tax Notes Int’l 1227, 1228 (2012).

337. “That is why, for example, U.S. withholding agents must sort through more than a hundred specially defined terms in these provisions. Similarly, it takes more than 80 pages of proposed regulations to cover what a withholding agent—such as a U.S. fund—must do to determine whether the nominal recipient of a payment is the true payee for FATCA purposes and then to determine the status of the payee under a wordy and convoluted classification framework.” Petkun & Presant, supra note 331.


339. Id. FIRPTA authorized the Treasury Department to promulgate regulations to require reporting in foreign persons holding direct investments in U.S. real property interests. Debate over the reporting system led to the tax withholding system currently in place, which makes it doubtful, despite the language of the law, that the Treasury will implement the reporting requirements any time in the foreseeable future. The foreign investor should carefully analyze the tax consequences of a proposed investment in the United States. These rules cover not only the taxation of gains on sales of U.S. real property, but also income from U.S. acquisitions and dividends from U.S. investments.

340. Temporary Regulations addressing the withholding requirements were published on December 31, 1984, and final regulations were adopted on December 18, 1986.

wise to create significant barriers of entry for foreign investments. There are many places for foreign wealth to invest.

Special interest groups have provided economic studies done to promote the premise that with FIRPTA in place, foreign investment will not flow into the U.S. real estate market. “FIRPTA continues to discourage foreign investors at a time when stresses in U.S. commercial real estate are a major threat to America’s economic recovery.” \(^\text{342}\) Or as the 2011 study states,

addressing these deterrents would correct the inequitable tax treatment of foreign equity investment in U.S. real estate and encourage the flow of additional capital to domestic assets. Under a relaxed or repealed FIRPTA regime, the magnitude of capital that would be made available for U.S. real estate investment would grow immensely. \(^\text{343}\)

Clearly, the sky is falling and the only way for foreigners to invest in the U.S. real estate market would be for the elimination of FIRPTA.

The only problem is that there has been no study that has been able to quantify that foreign investment is inhibited because of FIRPTA. The structuring mechanisms in place make FIRPTA elective for foreign investors. \(^\text{344}\) The argument that FIRPTA is somehow preventing inbound investment simply cannot be supported.

Under a normal global economic competition paradigm, the premise for relaxed investment barriers would ring true. Since the economic strains are not limited to the U.S. or a few countries but exist on a global scale, however, investors are looking for different investment drivers. These drivers continue to favor investment in countries with fully developed legal structures, credit structures, and creditor protection mechanisms. \(^\text{345}\) These are all strengths of the United States—a sophisticated and active credit market and the developed U.S. bankruptcy system. \(^\text{346}\)

This contrarian viewpoint, that the United States is an attractive market regardless of the tax implications, is supported by the data. In fact, the 2011 Real Estate Roundtable commissioned study reiterates this fact: “Strong demand already exists for investible U.S. real estate assets for their relatively stable risk-adjusted returns in the long run and for portfolio diversification benefits.” \(^\text{347}\) These conditions create an ideal portfolio investment for a foreign investor. The United States becomes

\(^{342}\) BAILY & SLAUGHTER, supra note 5, at 11.

\(^{343}\) ROSEN ET AL., supra note 5, at 2.

\(^{344}\) Kaplan, supra note 11, at 1114.

\(^{345}\) See, e.g., Jackson, supra note 2, at 2 (The largest investors are the most developed countries. “With over $441 billion invested in the United States, the United Kingdom is the largest foreign direct investor, as is indicated in Table 1. Japan is the second-largest foreign direct investor in the U.S. economy with about $209 billion in investments. Following the Japanese are the Dutch ($240 billion), the Germans ($215 billion), the Swiss ($212), the Canadians ($211 billion), the French ($199 billion) and Luxembourg ($190.”); Liang and Yoon, supra note 2, at 6.

\(^{346}\) See supra notes 13–15 and accompanying text.

\(^{347}\) ROSEN ET AL., supra note 5, at 4.
even more attractive as more and more of the alternative countries to the United States suffer setbacks (e.g., Spain, Greece, Italy, and France).

Thus, the current market dictates that the United States should increase its aggressiveness in the tax collection marketplace. The upside to a more active and aggressive collection mechanism is more revenue and a more transparent system for the United States. Additionally, when and if the economy improves in the future, the groundwork will be in place for a more expansive collection regime. The downside to this type of regime is lower future investments and a potential drawback of current investments. These risks are currently limited, however, given the limited ability to effectively redistribute these assets globally.

The proposed reform will lead to accurate data of foreign investment in the U.S. real estate market. In the event this reporting leads to drawdowns by foreign investors, the underlying FIRPTA statute can be examined by Congress. The reason that the legislative attempts at reform continue to fail to garner majority support is because no one can quantify the impact of FIRPTA, both on foreign investment and revenues. This reform will allow the government not only to quantify the magnitude of the problem, but also to see if there is an investment distortion caused by FIRPTA.

D. Limitations to a FATCA Style Regime

There might be a disagreement in the use of a FATCA type regime to FIRPTA. FATCA was driven by an attempt to identify tax evaders who hid behind bank secrecy laws. In essence, FATCA did not change the substantive tax liability; rather, it enlisted third parties, e.g., the banks, to enforce existing laws. FIRPTA avoidance is different in that foreign investors avoid FIRPTA through permissible legal structuring. What is suggested is basically a look-through rule, which is not a reporting rule, but maybe a complete substantive revision of FIRPTA.

This is a partially accurate statement. FIRPTA has two main components: the collection of tax, and the investigatory powers of the IRS. Through the structuring mechanisms, foreign investors are not only gaining tax-free distributions not subject to reporting, but also are, avoiding the IRS investigatory powers. This is factually similar to the foreign bank account reporting problem. Moreover, a pure reporting position is not necessarily an indictment of the underlying structure. Rather, it provides the IRS an opportunity to ensure that corporate form and rules are in compliance. Currently, there is no such opportunity. Further, it al-

348. Grinberg, supra note 325, at 334.
349. Id. at 334 n.104.
351. Grinberg, supra note 325, at 308.
352. Herzig, supra note 165, at 1102; see also, Joseph M. Dodge & Jay A. Soled, Reporting Tax Basis: Dawn of a New Era, 110 TAX NOTES 784 (2006).
allows identification of the true owners of the underlying property for further compliance with other important rules, e.g., CFIUS. 353

There is a clear trend in the identification of taxpayer positions that might draw the attention of the IRS. In the corporate context, there are new rules relating to uncertain tax positions. 354 Even though the structure and ultimate tax treatment might be valid, there is a requirement that large corporations report uncertain tax positions on their returns. 355 This is not an indictment of the position, but rather an opportunity to examine the position. If the underlying transaction is proper, the IRS will respect the form. 356

The reporting regime of a FIRPTA version of FATCA allows the IRS to pierce the corporate veil and examine both that the corporate form is in compliance and that the owners of the underlying property are proper. This regime will allow the IRS to easily find the game players associated with FIRPTA avoidance. For example, the group of people that utilize aggressive positions such as the total return swap to avoid FIRPTA will no longer be under the radar. 357 As we have seen in the area of 1099 reporting, adding disclosure increases compliance. 358

E. Implementation Structure Through Back-up Withholding

FIRPTA is unusual because it results in various distortions. If the ultimate goal of the tax code is to increase efficiency by preventing distortions in decision-making, all investments by foreign investors should

353. See supra notes 293–94 and accompanying text.
356. In the event that the IRS does not respect the form, the taxpayer may challenge in the courts. See, e.g., United Parcel Serv. v. Comm’r, 254 F.3d 1014, 1016–17, 1020 (11th Cir. 2001) (generating deductions for insurance premiums paid to a foreign affiliate); IES Indus., Inc. v. United States, 253 F.3d 350, 352–55 (8th Cir. 2001) (shifting of foreign tax credits and generating capital losses); Compaq Computer Corp. v. Comm’r, 277 F.3d 776, 780, 786 (5th Cir. 2001); 106 Ltd. v. Comm’r, 136 T.C. 67, 70 (2011); Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 56–57 (2007); see also Michael Doran, Tax Penalties and Tax Compliance, 46 Harv. J. on Legis. 111 (2009); Sarah B. Lawsky, Probably? Understanding Tax Law’s Uncertainty, 157 U. Pa. L. Rev. 1017 (2009).
357. “In order to avoid the application of Code § 897 but still participate in the U.S. real estate market, some foreign persons have attempted to use certain derivative products or financial instruments to create a synthetic long position in U.S. real estate. Although the use of options or forward contracts clearly would not accomplish this result, a total return equity swap may achieve this objective.” Jeffrey L. Rubinger, Can FIRPTA Be Avoided With Financial Instruments?, FLA. B.J., Mar. 2004, at 44, 44.
358. Herzig, supra note 165, at 1079.
be treated in the same manner. FIRPTA provides a zero rate to investments in public REITs and a low rate to leveraged blockers, so there is an incentive to invest through those mechanisms rather than directly in real property. Although the result is clearly distortive, the question is whether it is inefficient. If REITs or other investor-arranged pools are a more efficient way to pool investment in real estate, perhaps the tax law should favor them over direct investment. After all, most capital gains are not taxed to foreign investors. A risk then in increasing the tax compliance, collection, and possible rate on this tax would be to potentially increase the distortion.

These distortions cannot be remedied through legislation alone, however. The structuring mechanism and even the use of derivative contracts will always allow foreign investors to avoid detection. A reporting system like FATCA will allow the identification of all participants. But the long-term solution is to move to a back-up withholding system.

Specifically, the proposal would be for all buyers of U.S. real property to receive either a W-9 or appropriate W-8 from the seller or to withhold. If the buyer withholds, the foreign investor would be eligible to file a return for a refund. The question would be much like FATCA, i.e., how much independent investigation would a buyer of real estate have to engage in? The concern is that even with this regime, the reporting could not reach foreign investors in leveraged blockers or REITs. For example, if one purchases U.S. real property (my house, for example) from a U.S. corporation and it provides me a W-9, is there a requirement that the individual requests to determine if the entity is leveraged and/or has foreign shareholders? If so, how much can the buyer rely on the certification, or does the buyer need to make an independent investigation? For banks, this requirement is not onerous and fits with their existing know-your-customer requirements. Additionally, there should be a concern about the “moms and pops” buying their apartment from a non-resident. How will they comply with a FATCA-like regime? Today the only requirement is to ask for a FIRPTA certificate.

Additionally, publicly traded REITs with less than 5% shareholders presumably would be hard pressed to independently confirm the residence of all shareholders, especially if it is highly traded. Being able to rely on withholding forms solves this, but it just returns us to the structuring issue. Further, this might lead to the failure to consummate certain transactions where, for example, cash flow is instrumental.

The only pure solution is mandatory backup withholding on all sales of U.S. real estate (except maybe U.S. individuals) and make the seller file for a refund. The main barrier to the implementation of the plan

359. Thus, portfolio interest is inefficient and distorts decision-making because it applies a zero rate to most bonds but a positive rate on dividends.
360. Presumably, foreign investors could invest in non-real property equities, but there is a rather inelastic market for U.S. real property.
361. But often this requirement is not complied with either. Thus adding compliance requirements is not truly distortive.
would be determining who is tasked with the withholding. The most logical choice would be the escrow companies or closing attorneys. Since they are in possession of all closing documentation and closing parties, they are in the best fiduciary-type position to collect the data, much like banks under FATCA. If a party did not want to comply, then the withholding would be done at close. Tasking either the escrow company or the closing attorney would be going well beyond their past roles and would most likely generate additional costs.

VI. Conclusion

The federal government has come to view foreign investment in U.S. real estate as a natural part of the global real estate market, but it has kept FIRPTA in place because of the revenue that the law generates. More recently, pressures from the turmoil in commercial real estate have sparked a number of federal legislators to support major changes to the FIRPTA rules. These rules would likely lessen the tax consequences for foreign investors and encourage more investment in U.S. real estate from abroad, particularly in distressed assets.

This position is flawed. The United States should take an aggressive position with regard to an expansive reporting regime under FIRPTA or should use FIRPTA as precedent for the taxation of indirect asset sales currently. Rather than continue with the current policy of lessening the rule under FIRPTA, as was proposed in 2010 and 2011, the rules should be tightened. There is an artificial narrative that the rules need to react to the investors rather than have the investors react to the rules. The reason that FATCA works is because there is a need to invest or transact business within the United States. These same reasons exist in the realm of U.S. real property. There are few investment-grade assets available globally, and the United States has a significant number of those assets. Therefore, the United States should use this strategic advantage to tighten its grip on collection of tax revenues from foreign investors.

Moreover, if there is a superior right to tax and FIRPTA is normatively correct, the use of FIRPTA principals by a sovereign to use a FIRPTA-like regime can cure country-specific failings in both international tax law convention and treaties. For example, FIRPTA-like rules could be more expansive, such as precedent for all indirect asset sales.